The Eichleay Formula

in

Naval Facilities Engineering Command

(NAVFACENGCOM) Contracting

by

Shawn J. Bergan

Submitted in partial fulfillment of the
requirements for the degree of

Master of Civil Engineering

Texas A&M University

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ABSTRACT

When a delay causes contractors to be shut down or turn idle for a period of time, fixed overhead as well as general and administrative expenses continue to be incurred. However, the amount of direct costs to which these expenses can be allocated or expensed is reduced. The result is an amount of overhead that is unabsorbed, which can be allocated to that specific delay. Various pricing methods for calculating these unabsorbed home office overhead expenses currently exist in the construction litigation process today. The per diem Eichleay method is the most frequently utilized method.

In this era of financial austerity, the armed forces are facing challenges to maintain operational readiness with fewer personnel and leaner operating capital due to shrinking defense budgets. One way to optimize these precious and limited resources is the efficient and effective use of construction funds and personnel in Naval Facilities Engineering Command (NAVFACENGCOM) construction administration.

This report focuses on the commonly utilized Eichleay method of computation, as well as alternative methods currently utilized in today's construction industry. Research and analysis was conducted on current litigated construction claims resulting from disputes involving the Eichleay formula. Assumptions about the Eichleay formula method and its shortcomings have been provided. Emphasis on utilizing other methods of calculating these damages to the contractor as well as situation specific modifications of the Eichleay formula itself are also included. Conclusions were drawn from the data that identify significant strengths and weaknesses among these common place case situations. Recommendations were made for future possible improvements regarding the recognition and avoidance of potential claims by contractors.

The target audience of this report is the junior construction project manager (Naval Civil Engineer Corps officer/civilian government personnel) and is to be utilized as a guide in the NAVFACENGCOM construction organization atmosphere for calculating legitimate contractor's unabsorbed home office overhead expense for a government caused suspension, delay, or disruption to the contract performance.

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QUALIFICATIONS OF A NAVAL OFFICER

It is by no means enough that an officer of the Navy should be a capable mariner. He must be that, of course, but also a great deal more. He should be as well a gentleman of liberal education, refined manners, punctilious courtesy, and the nicest sense of personal honor.

He should be the soul of tact, patience, justice, firmness, and charity. No meritorious act of a subordinate should escape his attention or be left to pass without its reward, even if the reward is only a word of approval. Conversely, he should not be blind to a single fault in any subordinate, though, at the same time, he should be quick and unfailing to distinguish error from malice, thoughtlessness from incompetency, and well meant shortcoming from heedless or stupid blunder.

based on the letters of John Paul Jones

CHAPTER I

INTRODUCTION

On a given business day, there are undoubtedly tens or hundreds of Eichleay unabsorbed home office overhead formula claims pending in litigation situations around the country [Mohn, Civil Engineering, 1990]. Blindly relying on this formula may bring unrealistic and impractical views of the formula's outcome, many of which are far too often exaggerated and illegitimate.

In this era of financial austerity, the armed forces are facing challenges to maintain operational readiness with fewer personnel and leaner operating capital due to shrinking defense budgets. One way to optimize these precious and limited resources is the efficient and effective use of construction funds and personnel in Naval Facilities Engineering Command (NAVFACENGCOM) construction administration.

A. Background

The Navy's authorized and mandated agency authority for construction contracting, the Naval Facilities Engineering Command (NAVFACENGCOM) is headquartered in Alexandria, Virginia. It is comprised of over 1,450 naval officers and 22,000 civilians located throughout the world.

NAVFACENGCOM provides all construction, engineering, and public works administration and service requirements for its personnel and tenants

through a detailed chain of construction administration personnel [U.S. Navy, CECOS, Basic Qualification, 1989].

In fiscal year 1993 (01 Oct 92 - 30 Sep 93), the Naval Facilities Engineering Command awarded over 16,500 construction and public works related contracts totaling over $1.6 billion. In contrast, as of 30 October 1993, NAVFACENGCOM had a total of 518 active claims pending with the Armed Services Board of Contract Appeals (ASBCA) for a total of over $594 million. Because of the dispersed nature of these claims and the various subcatagories involved, this report will focus on the nature of contractor's indirect home office overhead calculations resulting from government caused construction delays primarily utilizing the Eichleay method of pricing.

B. Problem Statement

Naval officers assigned to contract administration positions are required to administer construction and construction related projects or services relatively early in their career compared to their civilian counterparts. Some are afforded formal training in contract administration, while others must rely on in-house or on-the-job training from other experienced personnel to gain required skills. Inadequate construction administration skills and knowledge may result in poorly executed construction projects. This may possibly lead to increased cost and time required to complete the work.

Because of the litigious nature of the construction industry today, the construction administrator and the contractor should focus on a fair and equitable

compensation to the contractor for damages resulting from the government's delay in the construction progress. One form of damages is the contractor's home office overhead expenses that were not absorbed during the delay process. Claim conditions undermine all professional relationships, contributing to distrust and frustration. The results often include unnecessary cost overruns and spiraling litigation expenses [Mohn, Civil Engineering, 1990].

As with any complicated approach, no one approach will be the answer that satisfies everyone. The focus of this report will be the ever tried Eichleay method of calculating these unabsorbed home office overhead costs.

C. Scope

Because of the breadth of possible litigation and highly controversial issues in the Navy's construction industry today, this report will be confined to the examination of the Eichleay method of calculating contractor's home office overhead expenses during government caused construction delays. This report will acknowledge other methods of calculating this specific type of damage to the contractor and will provide an analysis and observation of various methods utilized today in the construction industry.

Specifically, this report will:

- Address the Eichleay method as well as appraise other methods of analysis.

- Identify major assumptions and criticisms involving the Eichleay method.
- Research analysis of methods employed by the construction industry.
- Identify beneficial construction administration courses currently offered in the Navy.
- Make cost-effective recommendations to improve the administration of this potential claim situation.

D. Approach

There are three major areas of effort detailed in this report. These are to evaluate and analyze the various methods available to calculate contractor's home office overhead damages as a result of government (owner) caused construction delays; to research innovative and cost-saving calculation methods utilized by the construction industry that can be incorporated into the construction administration training programs; and to recommend cost-effective measures to improve training for contract administration personnel.

Current litigated cases involving the calculation of contractor's home office overhead damages as a result of government (owner) caused delays were documented to analyze the chosen method utilized or modified. A comparison of the awarded damages versus the original claimed amount is also provided to illustrate the often over emphasized nature of the damages involved.

A literature review examined the calculation methods commonly employed by the Navy and the construction industry for such damages claims. The goal was to identify cost-effective construction administration tools, techniques and guidance that can be employed by the young construction contract administrator; be it civilian or Navy Civil Engineer Corps officer alike.

E. Problem Structure

The first question this report will address is: What is unabsorbed home office overhead and, what are the current methods of calculating contractor's home office overhead damages as a result of an owner generated delay in the construction? This question will evaluate the various methods available, the methods that have been tried time and again, the Eichleay method, and the specific details regarding each of these methods.

The second question is: What are the major assumptions and concerns related to the Eichleay method of calculating contractor's home office overhead damages as a result of owner caused construction delays? This will be answered through research involving litigated cases as current as June 1994 while looking at the long history of the Eichleay method. A recent challenge to the Eichleay method was highlighted to indicate current approaches to the problem of the Eichleay workhorse formula in the industry today as and accurate measure of indirect contract cost in terms of a claim for delay damages that are excusable and compensable (*Capital Electric vs. U.S.*, 729 F2d 743, 746-747 [C.A.F.C. 1984]).

The third and last question is: How can we provide better training and knowledge within current time and budget constraints? This will be answered

through an analysis of current Navy training courses in construction administration as well as applicable training methods utilized in the construction industry. The recommendations in this report will be most effective if they are cost effective, pertinent to contract administration, and capable of being implemented in a timely and productive manner.

CHAPTER II

NAVY CONSTRUCTION CONTRACT ADMINISTRATION

Laws and Regulations give contracting authority to agency heads, including the Secretary of the Navy. The Secretary has established several of these "contracting activities", one of which is the Naval Facilities Engineering Command (NAVFACENGCOM). NAVFACENGCOM is headquartered in Alexandria, Virginia and comprised of over 1,450 naval officers and 22,000 civilians located at various installations throughout the world.

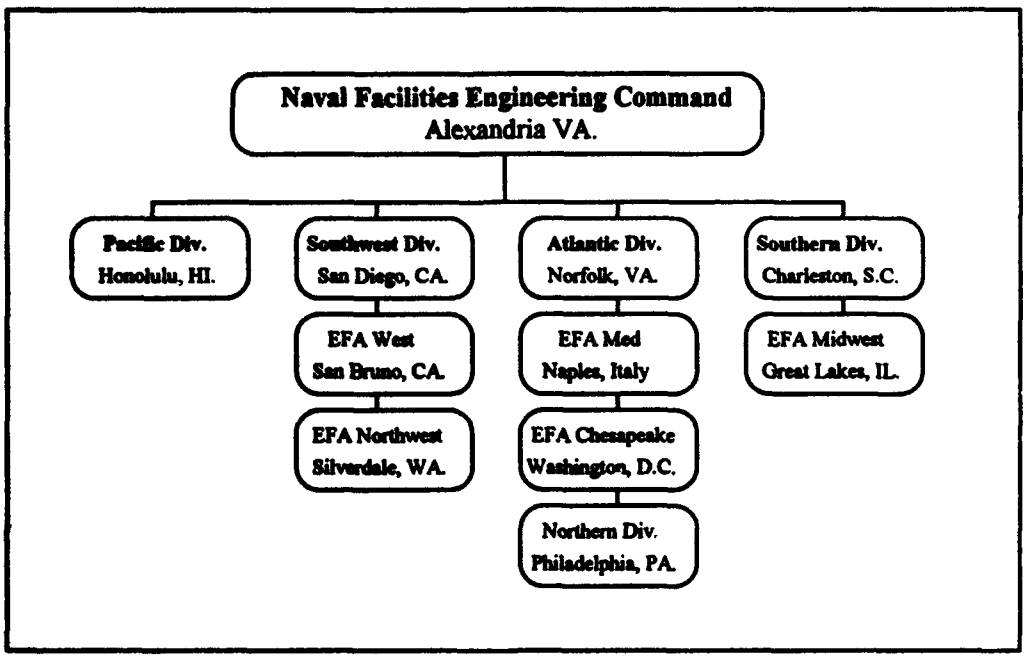

Figure 2.1 NAVFACENGCOM Organization

The organization headquarters is supported by ten separate Engineering Field Divisions/Activities (EFD's/EFA's) located throughout the United States. These EFA's and EFD's provide a supervisory role to each individual field office as illustrated in Figure 2.1, NAVFACENGCOM Organization.

NAVFACENGCOM appoints "Contracting Officers" who have contracting authority and responsibility, ultimately to the Commanding Officer, NAVFACENGCOM. These Contracting Officers enter into, administer and terminate contracts. They are responsible for ensuring performance of all necessary actions for effective contracting. Only Contracting Officers are authorized to enter into, modify or terminate contracts. The Contracting Officer (GS-1102 and CEC Officers) must be warranted (SF 1402).

Contracting Officers are located in various contracting field offices that provide construction as well as service needs. These various areas include:

- Naval Supply Centers,
- NAVFACENGCOM Engineering Field Divisions/Field Activities,
- Public Works Centers (PWC's) and Officer in Charge of Construction (OICC) Offices,
- and various activities in Supply Departments and Public Works Departments (PWD's).

The OICC staffs are the supporting activities for the Resident Officer in Charge of Construction (ROICC) activity field offices. These "field offices" are located at most naval installations throughout the United States and the world. Field offices are generally lead by a senior officer depicted as the Resident Officer in Charge of Construction. Figure 2.2, Typical ROICC Office Organization, illustrates this organization.

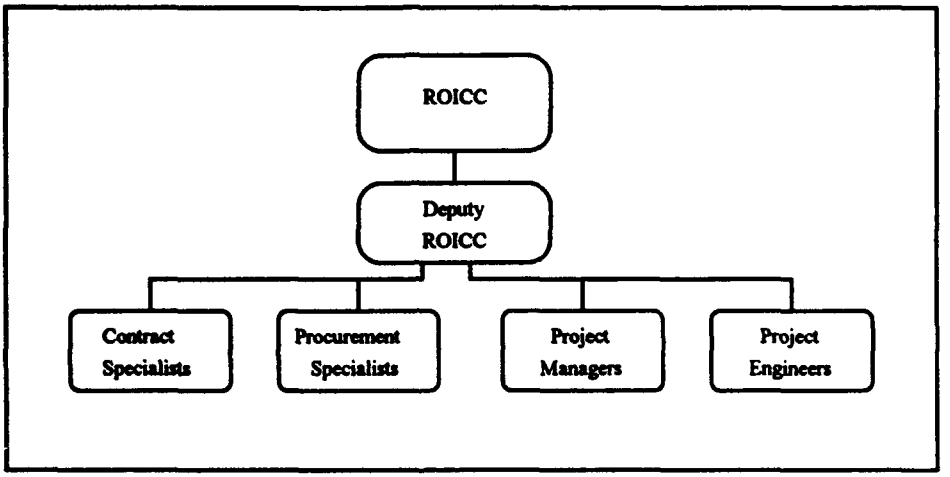

Figure 2.2 - Typical ROICC Organization

Figure 2.2 illustrates a simplistic version of a typical ROICC staff. New procurement regulations have mandated very distinct and separate procurement and engineering functions that are simplified in this illustration.

The size and seniority of the ROICC staff is dependent upon the scope of contracting responsibility and volume. Generally, the ROICC is a Navy commander or lieutenant commander with a civilian GS-12/13 deputy. The contract and procurement specialists, as well as the project

engineers, are generally GS-5 through GS-12 ranks. The project managers, the target audience of this report, are typically junior officers, ensign to lieutenant, with limited experience in the contracting field and contract administration skills.

In fiscal year 1993 (01 October 1992 - 30 September 1993) the Naval Facilities Engineering Command (NAVFACENGCOM) awarded 16,585 construction and public works related contracts totaling over $1.6 billion. These awards were distributed among the various divisions mentioned earlier and illustrated in Figure 2.1.

CHAPTER III

HOME OFFICE OVERHEAD AND CALCULATION METHODS

Various pricing methods for calculating unabsorbed home office overhead expenses currently exist in the construction litigation process today [Carpenter/Cushman, 1990]. The Eichleay method is the most frequently utilized in the industry. This chapter will provide an explanation of unabsorbed home office overhead, the unabsorbed home office overhead theory, alternative methods of computation and analysis of calculating home office overhead expense, as well as the most common Eichleay method of computing the value of the unabsorbed home office overhead costs.

A. Unabsorbed Home Office Overhead

The costs of delays can involve many elements. Naturally, when a contractor is delayed, direct costs are affected. However, a contractor's efficiency, construction schedule, various impact costs, available favorable weather days, and home office overhead expenses may also be affected [Carpenter/Cushman, 1990].

When a delay causes contractors to be shut down or turn idle for a period of time, fixed overhead as well as general and administrative expenses continue to be incurred. However, the amount of direct costs to which these expenses can be allocated or expensed is reduced. The result is an amount of overhead that is unabsorbed, which can be allocated to that specific delay. In delay claims against the federal government, the contractor's right to recover unabsorbed home office

overhead was granted and awarded in *Combs v. United States* [103 Ct. Cl. 174, 1945].

It is well established that home office overhead expenses are a compensable element of damage. Direct billings in the time period during which they are anticipated are not realized when a construction project is delayed. As a direct result of this delay, home office overhead is said to be unabsorbed. However, there has been considerable difficulty in determining the most logical method of calculating such expenses or costs [Carpenter/Cushman, 1990].

Generally speaking, courts do not have sufficient information or capability to make detailed analysis of the contractor's overhead makeup. Consequently, unabsorbed overhead is usually defined by application of a formula. These formulas are generally only rough approximations of the detailed cost impact of the unabsorbed home office overhead and should be utilized with great care and caution. Generally, these home office overhead costs cannot be easily identified and presented as part of a claim. This should not, however, preclude the recovery of such unabsorbed home office overhead in accordance with the contractor's established bidding methodology and cost accounting techniques [Carpenter/Cushman, 1990].

At this time it is imperative that a differentiation be made between unabsorbed home office overhead expense and extended home office overhead expense. Extended overhead expense results from the realization that additional work is performed, exceeding the original scope of the contract.

B. Unabsorbed Home Office Overhead Theory

The theory of unabsorbed home office overhead is quite simple and straight forward [Carpenter/Cushman, 1990]. However, there is much litigation over whether the Eichleay formula accurately measures indirect contract cost in terms of a claim for delay damages that are excusable and compensable. A firm's management makes certain decisions as to what home office costs are to be incurred in the next fiscal period. These costs are based upon their estimate of the volume of work that can be accomplished to which these overall management expenses can be charged and properly allocated.

As an example, a firm anticipates it will accomplishes a larger volume of business in the next fiscal period. They then hire additional home office support personnel such as bookkeepers, time keepers, and additional computer hardware systems to process this additional volume. The field activities, therefore, must now absorb this additional home office expense during the course of the fiscal period. If the anticipated and planned activity or construction work does not occur because of a delay or a suspension of work, these home office expenses are therefore unabsorbed. They should be paid by the owner as a compensable delay in the form of an equitable adjustment to the contract. The theory pivots around the concept of a contractor's inability to absorb its home office overhead costs as planned because the supporting field activity could not continue.

Contractors utilize various methods in bidding their home office costs on major construction projects. Many contractors simply bid their home office expenses as part of a standard company bid markup on estimated direct costs, while others have a separate home office overhead rate which is applied to total

estimated direct contract costs. These rates are then usually adjusted periodically based on overall, company-wide home office expenses [Carpenter/Cushman, 1990].

Some contractors bid home office overhead expenses primarily as a function of time, while others subjectively bid some dollar amount for home office expense as well as profit based on a perception of what it takes to win a contract. Because of this lack of uniformity in the construction industry, the amount of home office expense which should be recovered as part of a typical change order modification to the contract is always difficult at best to resolve and provide a win-win situation. Therefore, the contractor's method of bidding and calculating home office expenses should always be considered and integral criteria when evaluating the reasonableness of a home office overhead claim resulting from a justifiable and compensable delay to that said contract.

Regardless of how contractors bid and compute their home office overhead costs, it can be said that overhead is a function of time rather than prime cost [Carpenter/Cushman, 1990]. An example in point. A $100,000 contract of an original completion period of four years will more than likely require a larger percentage of the company's home office expense than say a $200,000 contract with a contract completion period of one year.

Contract documents do not usually define how overhead is to be recovered on delay claims. Owners/owner's agents and designers negotiating the amount to which a contractor is entitled for overhead are likely to rely on the maximum percentage for change order overhead in the contract documents which the contractor has impliedly accepted by signing the contract. In other cases,

however, owner/owner's agents and designers may try to restrict the overhead allowance to the percentage of the prime cost which that the contractor utilized in bidding the original contract price. This appears logical since the contractor apparently accepted that percentage as adequate compensation to cover the overhead attributable to that project when it applied the overhead to its bid in the first place. However, these methods of determining an equitable home office overhead allowance may be unrealistic in settling delay claim issues. This is because the percentages used relate only to prime costs and are unrelated to the time element of the situation which is so critical in determining the overhead in the first place [Carpenter/Cushman, 1990].

For example, in bidding a project with $500,000 of prime or direct costs which is to be completed in two years, the contractor determines that a 15 percent markup on the prime or direct costs is adequate for home office overhead expense. This would equate to $37,500 per year of performance for home office overhead expense. Assume, however, that the prime or direct costs for which the owner eventually acknowledges through change order modifications totals $600,000 and requires an additional year to perform, extending the contract completion now to three years. If the owner pays only 15 percent on the additional $100,000 of bilateral agreed work, the contractor recovers only $15,000 for the additional overhead expense, or half of the annual overhead expense calculated in its bid in the third year. Settlement of home office overhead claims in delay damage situations based on a quick percentage method illustrated above may result in a devastating loss on projects that encounter that delay. Therefore, in presenting these unabsorbed costs, the pricing methodology must be one of the first items considered in pursuit of these delay damages.

C. Eichleay Method Alternatives for Unabsorbed Home Office Overhead Calculations

Various pricing methods for calculating unabsorbed home office overhead expense currently exist in the construction litigation process today. The Eichleay method is the most frequently utilized in the industry. This section will provide an analysis of the Eichleay method of computing the value of the unabsorbed home office overhead costs, as well as providing other computation and analysis methods available in the construction industry.

Formal training offered at the Naval Facilities Contract Training Center (NCTC) and the Civil Engineer Corps Officer School (CECOS), both located in Port Hueneme, California demonstrate three methods of calculating unabsorbed home office overhead expense. They include the percentage (NAVFACENGCOM standard and calculated), Eichleay (or per day/per diem) , and advance agreement methods [U.S. Navy, CECOS, Basic Qualification, 1989].

The NAVFACENGCOM alternates or standard overhead procedure for indirect costs for construction contracts is a method for which the modification to the contract is under $500,000 and where the value of the construction and time involved in performance are proportionate to each other. If this situation arises, the following may be used in lieu of requiring the contractor to submit a detailed breakdown of overhead:

- Field overhead = 10 % x direct costs
- Contractor overhead on subs = 5 % of subs price
- Home office overhead = 3 % of prime's field cost

- Or rates established by a current DCAA audit for that particular company.

In this situation, one must consider whether these percentages are fair and reasonable before allowing as settlement in the delay issue. To avoid possible duplication, this method should not be used if a contractor itemizes any cost that would normally be considered overhead [P-68 15.800(k)].

Whenever a contractor requests a contract price adjustment exceeding $500,000 the contracting officer shall promptly (whether in agreement on entitlement or not) request Defense Contracting Audit Agency (DCAA) to perform an audit on the entire proposal, direct costs, as well as the overhead costs. However, an audit requirement may be waived by a Level I Contracting Officer if the contractor does not desire an audit for that particular change to the contract [FAR 52.214-26 "Audit - Sealed Bidding"].

The "normal" NAVFACENGCOM procedure, or Eichleay (per day/per diem) may also be employed [FAR 31.203]. The conditions for this method are:

- The modification is under $500,000,
- The contractor decides not to go with the NAVFACENGCOM standard percentages,
- and the contractor does not have a current DCAA audit.

If the above conditions are met, then the contractor *must* itemize all of its indirect costs (home and field) as well as the direct costs involved. The contracting officer then must critique each item to determine which are allocable,

allowable, and reasonable as a first step in applying fair and reasonable indirect costs to the particular modification at hand.

NAVFACENGCOM states that the government position is to not alternate between the percentage method and the Eichleay (per diem or per day) method described above. *NAVFACENGCOM states that the standard or alternates percentage method is the normal method of choice, while falling back on the Eichleay method if the standard or alternate percentages are not acceptable to the parties* [U.S. Navy, CECOS, Basic Qualification, 1989].

NAVFACENGCOM also states that when utilized consistently it gives fair results, even though it is unfavorable to the contractor when the work takes some time to complete and is favorable when the time extension is minimal. This observation comes from the fact that the denominator in the equation is the delay plus the original contract duration in calendar days. The Eichleay (per day/per diem) method is appropriate when the time is much greater than the work, and when there is a delay or idleness. NAVFACENGCOM further states that this is easier to price and enforce when an advance agreement is made concerning the method (percentages and per day/per diem) of determination of the unabsorbed home office overhead expense is bilaterally agreed at the time of contract conformance.

These advance agreements are an increasingly popular alternative method that is available [FAR 31.109]. Federal Acquisition Regulation (FAR) 31.105 (d) encourages the use of advance agreements for home office overhead as well as construction equipment calculations and rates whenever possible.

These advance agreements should be:

- negotiated before the costs are incurred,
- executed by both parties, and
- documented by a price negotiation memorandum.

A proposal for advance agreement including overhead costs must contain the certificate at DFARS 52.242-7003. This is a requirement for the contractor to certify that the overhead costs are allowable.

D. Eichleay Method

The most frequently utilized formula to allocate unabsorbed home office overhead was first explained in *Appeal of Eichleay Corp* [ASBCA 5183, 60-2 B.C.A. (CHH) ¶ 2688, 1960]. This formula computes the daily amount of overhead that the contractor would have charged to the contract had there been no delay and gives the contractor the amount of overhead for each day of delay that has occurred during the performance of the contract. The Eichleay formula has been depicted as illustrated in Figure 3.1, Eichleay Method Formula. An Eichleay formula example is presented in Figure 3.2, Eichleay Method Formula Example.

Although the Eichleay approach was subject to intense scrutiny and met with some disfavor in the late 1970's, it is clear today that its acceptance in the federal and state courts has been reaffirmed and both scrutinized once again [*Capital Electric Co. v. United States*, 729 F.2d 743 (Fed. Cir. 1984]. It is also

Eichleay Formula

Step 1:

$$\frac{\text{Contract billings}}{\text{Total billings for actual contract period allocable to the contract}} \times \text{Total overhead incurred during contract period} = \text{Overhead allocable to the contract}$$

Step 2:

$$\frac{\text{Allocable overhead}}{\text{Actual days of contract performance}} = \text{Overhead allocable to contract per day}$$

Step 3:

Daily Contract Overhead x Days of Delay = Unabsorbed Overhead Amount Claimed

Figure 3.1 - Eichleay Method Formula

Eichleay Formula Example

Contract amount	= $500,000
Period of delay	= 30 calendar days
Contract period	= 365 calendar days
Contract period (including delay)	= 395 calendar days
Revenues during contract period	= $5,000,000
Overhead during contract period	= $1,000,000

Step 1: $\frac{\$500,000}{\$5,000,000} = 10.0\% \times \$1,000,000 = \$100,000$

Step 2: $\frac{\$100,000}{395 \text{ calendar days}} = \$253/\text{calendar day}$

Step 3: $\$253/\text{calendar day} \times 30 \text{ calendar days} = \$7,590$

Figure 3.2 - Eichleay Method Formula Example

now generally recognized that the use of the Eichleay method does not automatically flow from the event of the delay. The contractor must prove that there was a "pure" delay, that he suffered an actual economic impact, and that there was no additional work available during the period of the delay [*George Hyman Const. Co. v. Washington Metro. Area Transit Auth.*, 816 F.2d 753 (D.C. Cir.), 1987].

In order to recover, the contractor must show that he necessarily suffered actual damage because of the nature of the delay made it impractical for him either "to undertake the performance of the work," . . . or "to [cut back on] home office personnel or facilities [*Eichleay Corp.*, 61-1 BCA at 15, 117, 1960]. A contractor generally meets this requirement by demonstrating that the delay was sudden and of unpredictable duration. The clarifying litigated case regarding this point is *Capital Electric Co. v. United States*, 729 F.2d 743, 745-46 & 746 nn. 4-5 (Fed. Cir. 1984) [*George Hyman Const. Co. v. Washington Metro. Area Transit Auth.*, 816 F.2d 757 (D.C. Cir.), 1987] and will be discussed in the forthcoming chapter of this report. One court even rejected the use of Eichleay even though the completion of the project was significantly delayed; most of the contract billings occurred during the originally scheduled time for contract performance [*Berely Indus., Inc. v. City of New York*, 45 N.Y.2d 683, 385 N.E.2d 281, 412 N.Y.S.2d 589 1978].

When a contractor has suffered a loss from an owner delay, the application of the formula is basic in nature. The determination and calculation of the contract billings are not problematic, nor should the determination of the total delays of performance be difficult to ascertain and compute. The critical issue and source of

most scrutiny comes from the very makeup of the total overhead figure that is to be utilized in the application of the formula. This issue mainly arises from the allowability and applicability of overhead elements to the overhead pool. It is sometimes even argued at length that fundamentally allowable overhead elements must be fixed and not variable in nature. Often in claim situations, the Eichleay calculation is performed incorrectly or only in part correctly and yet its calculation and methodological problems are not probed. This is because much cross-examination fury is vented on the issue of whether or not the formula is applicable while little or no attention is paid to how the calculation was actually performed.

E. Allowability and Applicability of Overhead Elements to the Overhead Pool

In federal contracting, such as that with the Naval Facilities Engineering Command (NAVFACENGCOM) contracting, the Federal Acquisition Regulation (FAR) specifically provides that certain elements of overhead are not allowable costs, and that these costs should be eliminated from the overhead pool calculated by the contractor [FAR 31.205]. These elements are illustrated in Figure 3.3, Construction Contract Overhead Costs (Partial Listing). The Veterans Administration Board of Contract Appeals addressed these issues in *Salt City Contractors, Ltd* [VABCA No. 1362, 80-2 B.C.A. (CCH) ¶ 14, 713, 1980]. In this case, the delayed contractor claimed the following items as elements of home office overhead:

- plans and blueprints,
- workers' travel,
- bid bonds,
- auto expense,
- cleaning and maintenance,
- tools and supplies,
- insurance,
- depreciation,
- advertising and promotion,
- dues and subscriptions,

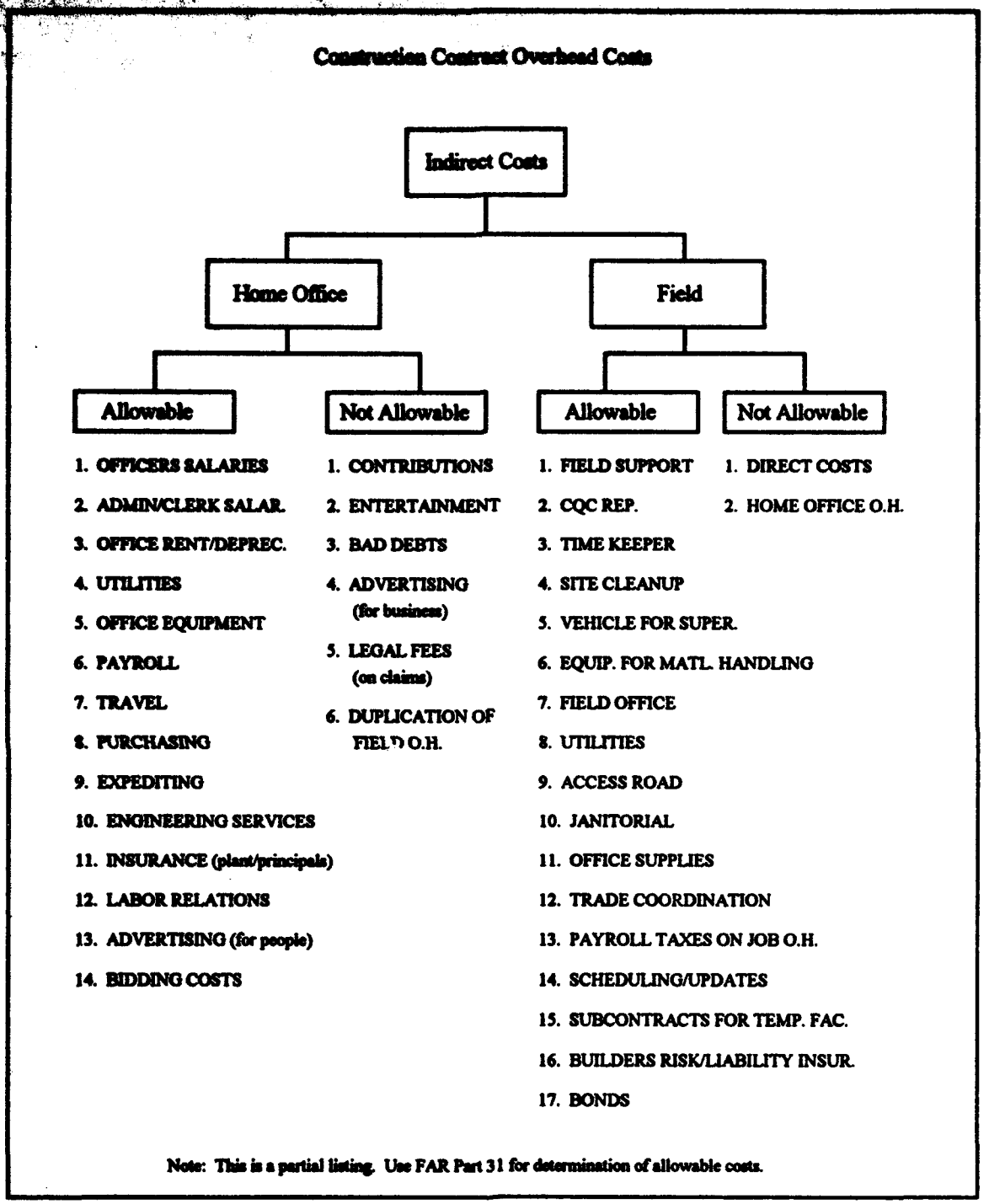

Figure 3.3 - Construction Contract Overhead Costs (Partial List)

- light and heat,
- interest,
- office expense,
- officers salaries,
- telephone,
- FICA expense,
- federal unemployment,
- and sales tax expense.
- penalties,
- legal and accounting,
- office wages,
- rent,
- travel and entertainment,
- state unemployment,
- state disability,

The government took the position that only fixed overheads were properly considered and sought to have Eichleay applied to only the following elements of the overhead pool: depreciation, utilities, officers salaries, and rent. However, the board only disallowed the inclusion of workers' travel, travel and entertainment, advertising and promotion, penalties, interest, and donations, noting:

> The other items listed as home office overhead expenses are generally allowable when reasonable. The burden of establishing that these are not reasonable expenses is on the Government (*Bruce Construction Corp. et al. v. United States* [9 CCF 72, 235, 163 Ct. Cl. 97 (1963)]. No evidence has been presented by the Government, nor does the record otherwise contain evidence, which would persuade us that these costs were not reasonable expenses incurred in the normal course of overall administration of [the contractor's] business [VABCA No. 1362, 80-2 B.C.A. (CCH) ¶ 72, 561, 1980].

With respect to the issue of fixed versus variable overhead elements, the board stated:

The Eichleay formula, in determining an average daily rate of home office expense, uses the total home office expense incurred during the contract performance. This necessarily includes some costs which may vary during the period. Even those costs which the Government defines as "fixed" costs may vary. For example the rent for office space may increase or decrease, and utility bills certainly vary, but these are without question, allowable overhead element items. It is generally accepted that the Eichleay formula is used primarily for construction contracts, where there is an assumption that almost all overhead is fixed, rather than variable, but this is not to say that overhead costs which do not remain constant are to be excluded solely on that basis [VABCA No. 1362, 80-2 B.C.A. (CCH) ¶72, 559, 1980].

CHAPTER IV

CRITICISMS OF THE EICHLEAY FORMULA METHOD

The Eichleay formula method is the method most commonly utilized and scrutinized in the United States construction industry to calculate a contractor's indirect home office overhead losses resulting from owner-caused construction delays [Mohn, Civil Engineering, 1990]. When a project is delayed or interrupted, the contractor may not be working to full capacity. Although the contractor is usually working on other projects, some overhead expense will be expended on those idle facilities and personnel. The Eichleay formula was intended to determine the amount of damages with respect to this compensable delay regarding the unabsorbed home office overhead costs.

As with any complicated problem, no one approach will be the correct or most correct answer to each and every situation that arises. This chapter will address questionable assumptions regarding the Eichleay Method as well as landmark cases and decisions since the birth of the Eichleay formula in 1960.

A. Questionable Assumptions

The allocation of indirect costs is usually accomplished by utilizing a certain "base", for example, labor cost, contract billings, machine hours, or a similar base. The Eichleay formula utilizes *contract billings* as a base in the calculation criteria [Carpenter/Cushman, 1990]. A ratio of the base for a specific project to the total base for all projects is utilized to allocate the indirect costs.

This is called "absorption costing" - the distributed cost absorbed by the projects [Carpenter/Cushman, 1990].

One of the criticisms of the Eichleay formula is that it may compensate the contractor for unabsorbed overhead whether or not the contractor's overhead rate has increased because of additional business, bad management, or decreased because of situations that may have developed independent of the project at hand [Carpenter/Cushman, 1990]. The Eichleay formula distorts the period utilized to calculate the daily overhead rate because it includes the period of delay.

Additionally, the actual home office expense included in the Eichleay calculation does not necessarily consider the intended home office expense which was not realized as a result of the delay. Some insist that the Eichleay formula should take into account the actual level of activity on the project during the delay period, not only the duration of the delay. Without reference to this level of activity on the project, the claim for the home office overhead would be the same under Eichleay whether or not the delayed critical work represented 100 percent or 10 percent of the project's activity.

Among the formula's detractors is Air Force Major David G. Anderson, who is one of the few authorities in the area of accounting-legal authority. Major Anderson, an attorney, CPA and certified internal auditor, demonstrated that the Eichleay formula relies on six questionable assumptions:

1) A proportional relationship exists between the contract billings and fixed indirect costs,

2) the indirect cost pool or base does not include any variable indirect costs,
3) during the delay, the contractor does not perform any work of value,
4) the contractor had been working at full capacity during the entire period of contract performance,
5) the delay's effect on the contract is the same, regardless of when the delay occurs, and
6) the period of the contract is an acceptable base period for accumulating fixed indirect costs.

The formula does not make adjustments for seasonal work fluctuations, substituted work during the delays, or the capacity at which the contractor was working before any delay began. In his doctoral dissertation (1988) and an American Bar Association monogram (1989), Major Anderson showed that the first and fifth assumptions are unsound from an accounting point of view because the relationships may not always exist in the simplified form that the formula implies. Major Anderson also states that the second, third and fourth require a detailed investigation of the contractor's activities, involving analysis of the actual costing methods and activity levels represented during the delay period. When all six assumptions are satisfied, the formulas results in under-recovery. When one or more assumptions are not satisfied, it results in overcompensation of the contractor [Mohn, Civil Engineering, 1990].

B. Landmark Challenges and Case Decisions

Appeal of Eichleay Corp

The birth of the Eichleay formula method of calculating unabsorbed home office overhead was in *Appeal of Eichleay Corp* [ASBCA 5183, 60-2 B.C.A. (CCH) ¶ 2688, 1960]. The Armed Services Board of Contract Appeals (ASBCA) devised a daily rate formula to estimate home office overhead. The board stated that the contractor need not prove a specific amount of overhead, but that a need only to assert a fair allocation to compensate for government delays which caused the suspension of the work. The formula was viewed by the ASBCA as the best way to allocate home office overhead incurred during a suspension of work when it was not practical for the contractor to undertake performance of other work which might have absorbed those costs [The Bureau of National Affairs, Inc., Federal Contracts Report, 58 FCR 17 d18, November 1992].

Berley Industries Inc. v. City of New York

In this case [45 N.Y.2nd 683, 385 N.E.2d 281, 412 N.Y.S.2d 589 (1978)], the court denied the use of the Eichleay formula because the contractor who was promoting it failed to prove that any expenses included in the overhead category actually increased because of the delay. The court was disturbed that the Eichleay formula produced a sum that was more than all the other damages claimed by the contractor. The court said that the Eichleay formula produced a figure with "chance relationship to actual damages". However, due to the length of the delay and the substantial home office costs involved, it is not surprising that the Eichleay formula produced such a large result. The court failed to recognize that protracted delays result in sizable overhead damages [Carpenter/Cushman, 1990].

Capital Electric Co. v. United States

This landmark challenge case [729, F.2d 743 (Fed. Cir. 1984)] resulted in the rejection of the General Service Board of Contract Appeals' (GSBCA's) assertion that the Eichleay formula produced a result that had little of no relationship to the contractor's actual injury and held that a contractor could recover home office overhead costs by the Eichleay formula method. Later cases have followed this court of appeals decision. This was in disagreement with the earlier GSBCA's decision of one year prior which did not allow the use of the Eichleay formula to calculate unabsorbed home office overhead in delay claims [GSBCA No. 5316, 5317, 83-2 B.C.A. (CCH) ¶ 16, 548 (1983)].

Kansas City Bridge Co. v. Kansas City Structural Steel Co.
Appeal of Savoy Construction Co.

In the Berley and Capital Electric cases the courts found that they [courts] should not assume that simply because a project is delayed, a contractor is entitled to recovery of unabsorbed overhead. Other courts have also recognized that entitlement to increase home office overhead must be proved before any formulas to calculate the amount of recovery should be employed.

In the Kansas City case [317 S.W.2d 370 (Mo. 1958)], the courts refused to apply an Eichleay-type calculation when evidence was lacking that the delays had caused actual misallocation of overhead expense. Similarly in *Savoy Construction* [ASBCA Nos. 21218, 21925, 22300, 22336, 22691, 22763, 22915, 80-1 B.C.A. (CCH) ¶ 14, 392 (1980)] a claim for home office overhead was denied because underabsorption or overabsorption of the home office overhead by the contractor's other work was not shown by the contractor. The courts looked but could not find

in either case that there was proof that the delay caused an increase or misallocation of overhead expense. Misallocation could not represent a damage unless the contractor would have, but for the delay, obtained other work sufficient to have absorbed the misallocated overhead expense. The necessary element to make the misallocable overhead recoverable to these courts was to show there were other jobs available which the other claimant did not bid on. Another way was to show that the contractor did not obtain additional jobs because claimants' resources were committed to the subject project because of the delay. Generally speaking, failure to show that other work was not available results in no recovery.

Although overruling the GSBCA in the court of appeals in the Capital Electric case, the courts believed that the Kansas City and Savoy courts are generally correct. The Federal Circuit suggests that one could recover for unabsorbed overhead by utilizing the Eichleay formula if one can prove that its bonding capacity had been impaired or that it had been unable to shift its work forces to other existing work. The court of appeals, however, rejected the requirement that the contractor must prove that absent the delay, the contractor would have obtained other work. The court of appeals held that the contractor need only to prove that the circumstances of the delay were such that it would not have been "practical and prudent" for the contractor to remove its labor and equipment from the delayed project site to perform work at other sites [Carpenter/Cushman, 1990].

The "practical and prudent" standard is a relatively easy standard to meet. The court of appeals in Capital Electric emphasized that "uncertainty of delays" would make it imprudent and impractical for a contractor to remove its forces from a delayed project. If the contractor had obligated itself to perform a new project

while waiting for the current delays to end, without knowing with certainty when the current delays would cease, it could suddenly find itself obligated to perform both projects, and be unable to do so. Therefore, a delay almost always leads to the uncertainty which makes obtaining other work impractical and imprudent. The uncertain duration of the delay should be part of the contractor's proof. Once this evidence is submitted showing that other work was not obtainable and thereby being imprudent and impractical, the burden proving that the delays did not damage the contractor now rests with the owner.

Southern New England Contracting Co. v. State

In agreement with the above was the case of *Southern New England Contracting Co. v State* [165 Conn. 644, 345 A.2d 550 (1974)]. It was found that a showing of lost opportunity was not required. The court held that if the contractor could prove that the delay caused an increased allocation of home office overhead, damages could flow without requiring the contractor to specify project opportunities lost as a result of that delay issue at hand.

Appeal of Abel Contracting Co.

If it can be shown that the contractor is able to substitute the work, a reduction in the amount of claimed underabsorbed home office overhead is due as was in the *Appeal of Able Contracting Co.*. In this case, the government was only liable for one-half of the contractor's home office overhead during the period of government-caused delay. Why? Because the government was able to show that the contractor was able to perform other work in at least one project during the delay period although they made no effort to do so [Carpenter/Cushman, 1990].

Contractors may avoid the problem of allocating unabsorbed home office overhead by coding variable overhead costs to the individual projects and defining that overhead on their bid sheets. This is in lieu of the sometime utilized "hoped-for" type of income markup or fee assessment. Records may be kept which accurately attribute the contractor's home office employees time and expense to specific activities and projects. A gain in overhead costing may be realized in today's increasing technological advances regarding computer hardware and software.

Regardless, contractors and owners (government) are advised to perform real time tracking of the effects, both indirect and direct, of a government caused delay. Professional overseeing of this analysis is a must if contractors desire to obtain recoveries to which they are entitled while at the same time restrict excessive intrusion into their daily business affairs and internal financial planning and strategies. The government may then provide an equitable adjustment to the contract that is reasonable and allowable assuming the conditions that merit such an adjustment are met.

CHAPTER V

EICHLEAY UTILIZED IN TODAY'S CONSTRUCTION INDUSTRY

While the history of Eichleay dates back some 34 years, the use of Eichleay for calculating contractor's unabsorbed and extended home office overhead damages as a result of government caused construction delays will continue with much vigor and vitality as in the past. To provide a broader focus on the use of the Eichleay formula, the citations below include the Eichleay formula situations in the extended home office overhead situation. The landmark challenges and case decisions regarding the use of Eichleay have provided a track record of victories and losses alike, many of which result from improper utilization and justifiable situations; rarely from the true sense of pure denial in proof of other more "correct" and "precise" methods of choice such as the percentage method of calculation.

This section provides a review of current opinions, litigation, and highlights of various claims, appeals, and decisions from the litigation and court systems available to each situation. The representation is chronological.

C.B.C. Enterprises, Inc. v. U. S. [CA FC, No. 91-5154, 20 Nov. 1992]

The Federal Circuit Court, affirming a Claims Court decision, declines to extend availability of the Eichleay formula to pure contract extensions, finding that to do so "would likely transform use of the formula from an exception to a rule."

"Where no element of uncertainty is imposed on the contractor, use of the Eichleay formula to calculate extended home office overhead is not permissible," the CAFC declared. "Such a limitation on the use of the Eichleay formula is reasonable because, after all, the Eichleay formula only roughly approximates extended home office overhead."

In its 1960 decision in Eichleay Corp., the ASBCA devised a daily rate formula to estimate home office overhead. The board stated that a contractor need not prove a specific amount of overhead, but rather need only to assert a fair allocation to compensate for government delays which caused the suspension of the work in the first place. The formula was viewed by the ASBCA as the best way to allocate home office overhead incurred during a suspension for work when it was not practical for the contractor to undertake performance of other work that might have absorbed those costs.

In the present case, a construction contractor's performance period was extended by the Navy on several occasions. One unilateral modification extended performance for 24 days and allowed $10,846 in additional direct costs, based on a fixed percentage mark-up of the direct cost incurred. Although the work was not suspended, delayed, or disrupted, the parties count not agree on compensation for the contractor's home office overhead, giving rise to the claim.

The contractor contended that use of the Eichleay formula should be permitted in any instance in which a contract modification results in the erosion of direct costs, because a percentage mark-up of the decreased additional direct costs will not allocate a fair proportion of home office overhead to the contract. The Contracting Officer (CO) denied the claim, stating that the Eichleay formula could

not be utilized to calculate extended home office overhead when additional work, not suspension of work, extends the contract performance period. The contractor appealed to the Claims court, which granted summary judgment to the government. The contractor then appealed to the Federal Circuit Court.

"While the contractor has stated that extended home office overhead expenses would not be calculated using the Eichleay formula for the majority of contract extensions, it has articulated only two occasions when the formula would be inappropriate", the Federal Circuit observed. The court pointed out, moreover, that the contractor had offered only its attorney's argument, with no empirical supporting data, to support contention that the formula would be inapplicable to the majority of contract extensions. Rather, it appeared likely that the greater part of all contract modifications would qualify for the Eichleay formula under the contractor's view.

The court found that the "contractor seeks a drastic shift in the circumstances which the Eichleay formula has been available for," the CAFC observed. "We decline the invitation to stand availability of the Eichleay formula on its head. The raison d'etre of Eichleay requires at least some element of uncertainty arising from a suspension, disruption, or delay of contract performance." the court stressed. Since the delays are sudden, sporadic, and of uncertain duration, it is impractical for a contractor to take on additional other work. In contrast, the Federal Circuit Court concluded that the contractor in this case negotiated a change order which extended contract performance for a brief known period of time. "Thus, computation of extended home office overhead using an estimated daily rate is an extraordinary remedy which is specifically limited to contracts affected by government caused suspensions, disruptions, and

delays of work." There by, the appeal was denied. [The Bureau of National Affairs, Inc., Federal Contract Report, 58 FCR 17 d18, 02 Nov. 1992].

In summary of this case, it was held that the court properly recognized that it was inappropriate to use the Eichleay formula method to calculate home office overhead for contract extensions. This decision was based on the fact that adequate compensation for overhead expenses may usually be calculated more precisely using a fixed percentage formula [The New York Publishing Company, The National Law Journal, 11 Jan. 1993].

Kirkham Constructors Inc. v. U.S. [U.S. FedCl, No. 93-256C, 22 Nov. 1993]

This claim involved two requests for equitable adjustments (rea's); one for $133,745 for "the impact on unchanged work caused by the numerous Change Orders issued during the project," and $104,903 for "unabsorbed home office overhead and field office cost caused by the defective specification and the failure of the Government to provide timely direction."

Where contract change orders clearly state that "no agreement can be reached regarding the contractor claimed costs for "extended overhead" and alleged government delays," the amount later claimed by the contractor for these costs was clearly "in dispute" at the time the contractor submitted its claim, the U.S. Court of Claims ruled.

Because the court also ruled that the claim did not fail to state a sum certain merely because a previous proposal requested a different amount, and that a

certification three months subsequent to the claim was not improper because it did not specifically reference that claim, it denied the government's motion to dismiss. The contractor appealed the Contracting Officer's (CO's) final denial decision to the ASBCA where then the ASBCA directed the Air Force to issue a final decision, but none has been rendered.

The court eventually found that the letters were not treated as pricing proposals, but were genuine claims for increased costs and that the language in the change orders also indicated that these were not simply pricing proposals [The Bureau of National Affairs, Inc., Federal Contract Report, 60 FCR 22 d19, 13 Dec. 1993].

Interstate General Government Contractors Inc. v. West [CA FC, No. 92-1430, precedential opinion, 06 Dec. 1993]

The Federal Circuit held that when a contractor meets the original contract deadline or finishes early despite government delay, it may recover unabsorbed home office overhead under the Eichleay formula only under three conditions. The contractor must show that from the outset of the contract that it:

(1) intended to complete the contract early,

(2) had the capability to do so, and

(3) actually would have completed early, but for the government's actions.

The court ruled that the contractor's proof was legally insufficient with regard to all three elements, and affirmed the ASBCA's denial of the claim for reimbursement. This was despite the ASBCA's application of an incorrect legal

standard concerning "standing by" for purposes of the Eichleay formula. The ASBCA, in holding that Interstate General Government Contractors Inc. (IGGC) was not entitled to recover alleged unabsorbed home office overhead caused by the government's delay in issuing a notice to proceed, found that IGGC was not on standby because the work force on the particular contract was reassigned to other work or let go.

The Federal Circuit Court made it clear that the board applied the wrong test. After ›oard issued its decision, the court went back to *C.B.C. Enterprises Inc. v. U.S.* [58 FCR 525] , and clarified the applicable test. The court stated that the standby test focuses not on the idleness of the contractor's work force (either assigned to the contract or the total work force, but on suspension of the work on the contract). The board's focus on the fact that the workers assigned to the particular contract were reassigned or let go confuses the issue of direct costs caused by idle workers or equipment at the site (not claimed in this case) with the indirect costs of home office overhead recoverable under Eichleay (which is the sum of the claim in this case). *The application of the Eichleay formula does not require that the contractor's work force be idle; it simply requires that overhead be unabsorbed because performance of the contract has been suspended or significantly interrupted and that additional contracts are unavailable during the delay when payment for the suspended contact activity would have supported such overhead.*

The court found that the contractor's evidence was legally insufficient to establish any of the three elements. The record contained no pre-delay performance schedule, and that the required nexus between the government delay

and a contractor's failure to complete performance at some unspecified earlier date cannot be shown merely by hypothetical, after-the-fact projections.

In the "normal" case, the delay extends performance of the contract beyond the original completion period, thereby increasing the period of time for which overhead is incurred. In such cases, the contractor can establish proof of standby and that there was an inability to take on the additional work. However, the court found that such a presumption does not apply in cases involving early or on-time completions. In these cases, the court found that unabsorption must be proven via the three part test mentioned earlier. [The Bureau of National Affairs, Inc., Federal Contract Report, 60 FCR 23 d15, 20 Dec. 1993].

Eurostyle Inc. v. General Services Agency (GSA) **[GSBCA, No. 12084, 04 Apr. 1994]**

The General Services Board of Contract Appeals (GSBCA) found that the Eichleay formula is not applicable to an appeal by a contractor for home office overhead costs attributable to a contract modification that added work and extended the time since there was no decrease in the contractor's direct costs. In this case, the contractor's direct costs increased, not decreased.

As stated many times in this report, the Eichleay formula, which was established by the Armed Services Board of Contract Appeals (ASBCA) in Eichleay Corp., ASBCA No. 5183 (1960), requires that the following calculations be made:

(1) the allocable contract overhead, computed by multiplying total overhead cost incurred during the contract performance period by the ratio

of the contract billings during the delayed contract to total billings during the contract period,

(2) the daily contract overhead rate, computed by dividing the allocable contract overhead by the days of contract performance, and

(3) the amount recoverable, computed by multiplying the daily contract overhead rate by the days of government caused delay.

Eurostyle was delayed in performing a GSA contract to renovate office space. Some of the time extensions which Eurostyle sought were granted, but the Contracting Officer (CO) did not apply the Eichleay formula in determining the amount of additional overhead to be paid. Further, Eurostyle apparently did not experience any suspension or slowdown of work in connection of the work in the project.

Eurostyle sought reimbursement of $130,662 in unabsorbed home office overhead. The CO denied the claim, prompting an appeal to the GSBCA. In *Wickham Contracting Co., Inc. v Fischer* [CA FC, No. 93-1146, 06 Jan. 94] the Federal Circuit held that the Eichleay formula, and not a "directly attributable" percentage, is the only proper method to be used in calculating unabsorbed home office overhead when a contractor otherwise satisfies the Eichleay requirements. Moreover, the court stated that the contractor could not expand the overhead pool by including direct costs, especially after withdrawing them.

The Wickham court affirmed the GSBCA's decision in *Wickham Contracting Co.* GSBCA No. 8675 (1992), in which the Board declined to allow Wickham to expand its overhead pool by including direct costs, and rejected the contractor's claim for an increased delay period because Wickham failed to show

that it would have finished by the projected early date. In Wickham, the court pointed out that contractors recover their direct costs allocable to the costs of a contract modification and their indirect costs, that every cost is on or the other, and that unabsorbed home office overhead is an indirect cost.

The court found that if a cost is directly attributable to a contract, then it is a direct cost, not an overhead cost. Where, as in this case, the government and a contractor have consistently treated a cost as overhead, it will not treat the expense as direct cost and order reimbursement. Absent a contracting officer or board decision denying such expenses as direct costs, the court would find itself lacking jurisdiction.

Wickham had argued that since 80 percent of its home office activity related to the contract, then 80 percent of the home office costs were directly attributable to the contract. However, the court pointed out that the contract did not cause 80 percent of the home office costs, since Wickham would have incurred the costs regardless of whether it undertook the contract. The court stressed, "Wickham fails to recognize that a cost is directly attributable to a contract only when the cost is caused by the contract."

The GSBCA in this case also cites the Federal Court's decision in *C.B.C. Enterprises v. U.S.* [978 F.2d 669 (1992((58 FCR 525)] which held that the Eichleay formula is not applicable to extensions of contract performance occasioned by modifications adding work to be performed. The court also stated that "the delay must reduce the stream of direct costs in the contract" for the formula to be appropriate.

The Federal Circuit Court denied a claim for recovery under the Eichleay formula where the claim for home office costs arose out of contract performance involving continuous original and additional changes or work rather than a suspension or hiatus in performance which would affect direct costs [*Community Heating & Plumbing Co. v. Kelso* [987 F.2d 1575 (1993)]]. These are the facts also in this case in point. This court also cited the *Interstate General Government Contractors Inc. v. U.S.* [12 F.3d 1053 (1993) (60 FCR 638)] in which the Federal Circuit ruled that a delay must constitute a de facto suspension of work which forces the contractor to stand by, unable to take on other work "when the suspension decreases the stream of direct costs against which to assess a percentage rate for the reimbursement."

The court here found that this was not the case. The specific here is that the stream of direct costs not only did not decrease, but increased. The board declared that, "the use of the Eichleay formula is not appropriate in this case, and that the appellant has been properly reimbursed for all its claims for an equitable adjustment called for by the contract modifications here involved [The Bureau of National Affairs, Inc., Federal Contract Report, 61 FCR 15 d19, 18 Apr. 1994]."

***Ranco Construction Inc. and Reese Construction Inc. , a Joint Venture v. General Services Administration* [GSBCA, No. 12051 (11312), 13 May 1994]**

While Ranco Construction Inc. and Reese Construction Inc. (Ranco-Reese), a Joint Venture, were performing a construction contract for the General Services Administration (GSA), GSA ordered a cessation of work. After more than 500 days had passed, GSA directed the contractor to resume its efforts. During the period of the delay, Ranco-Reese's bonding capacity increased from $1.5 million

for a single contract and $3 million for all work in hand to $2.5 million for a single project and $5 million for all work in hand. Its total billings increased from $1.7 million in fiscal 1988 to $2.4 million if fiscal 1990. Ranco-Reese did not reach its bonding capacity during the period of time work was suspended.

Ranco-Reese submitted a later claim for extended home office overhead for the period of the delay, based on the Eichleay formula. The parties crossed moved for summary relief on the issue of entitlement, which meant that both parties agreed to have the judge decide the case in whole instead of a jury.

The GSBCA, in an opinion, denied the motions. The theories advanced by the parties were "too simplistic for resolution of the case," and the uncontested facts too limited to be supportive of a more complex analysis.

Once again, the established three prerequisites to the Eichleay formula as set by the Federal Circuit in Interstate General Government Contractors Inc. v. West (60 FCR 638) are:

(1) the government must have caused a suspension, disruption, or delay in the performance,

(2) the contractor must consequently have been placed in a standby position, and the

(3) contractor must have been unable to take on other work in order to mitigate the unabsorbed home officer overhead.

Ranco-Reese asserted that the delay in performance was caused entirely by the government, and that is was consequently required to stand by, ready to resume work at any time, for more than 500 days. They maintained, without

support, that because they were required to be prepared to resume the work, they could not release the capacity committed to the suspended contract to new work that would absorb the overhead costs that would have been borne by the GSA contract in question. Ranco-Reese also maintained that whatever growth they achieved during the period of the delay was independent of the fact that performance of this contract was suspended. According to Ranco-Reese, reading the third part of the test to give the government the benefit of the contractor's efficiency in procuring new work would "result in a windfall for GSA and exact a penalty from Ranco-Reese."

GSA admitted that it caused the delay in performance and that the contractor had to remain prepared, throughout the suspension period, to return to work. However, it maintained that Ranco-Reese did not show that it suffered any damages as a result of the delay. Permitting recovery in the absence of damages would give a windfall to the contractor, the government contended.

The Board denied both motions, stating that Ranco-Reese's position did not give effect to the third part of the court's test for Eichleay eligibility mentioned previously, and the contractor likewise was too simplistic. The fact that the contractor's business was larger at the end of the suspension period than that at the beginning is not proof that Ranco-Reese suffered no harm in the situation.

If the contractor could show that it predicated its allocation of overhead on the assumption that it would receive funds from new projects as well as this one, the growth in the size of the business might not have absorbed the overhead expected to result from the current contract. Ranco-Reese might have allocated its overhead in such a way that jobs begun after the performance of the GSA contract

were suspended could not have covered all the overhead associated with the contract.

In summary of these opinions, litigation, and highlights, conclusions drawn on the use of the Eichleay formula with regard to the eligibility for recovery are that measurements in increments of time less than the entire period of the delay should be considered in the calculation. If, during the suspension period, the contractor was able to secure additional contracts through which home office overhead initially allocated to the contracts could be absorbed fully during some months, but not for others, have an impact on the recovery?

The issue regarding the mitigation of damages is also considered. If an award made through the application of the formula might be reduced by the amount of mitigation, one might question whether Eichleay is intended to bestow on a contractor recovery greater than the damages the firm actually sustained [The Bureau of National Affairs, Inc., Federal Contract Report, 61 FCR 15 d19, 18 Apr. 1994]?"

CHAPTER VI

CONCLUSIONS

This report studied the use of the Eichleay formula method in the calculation of a contractor's unabsorbed home office overhead costs as a result of a government caused suspension, disruption, or delay in the contract performance. Landmark challenges and case decisions regarding the use of the Eichleay method, as well as alternative methods such as percentage and advance agreement were evaluated and studied. They indicated that:

- Improper utilization and justifiable situations were usually the justification for denial in such situations.
- Case situations were rarely denied from the true sense in proof of other more "correct" and "precise" methods of choice such as the percentage method of calculation.
- Current opinions, litigation, and highlights of various claims, appeals, and decisions from the litigation and court systems available to each situation mirrored a balance of the landmark challenges and case decisions regarding justification of method utilized and decision in kind.

The literature review and research indicates that there may be four approaches to this complicated, yet simple potential claim situation. They are:

- Lobby Congress to conduct a study and draft a contract clause or replacement formula, which will be used in federal contracts and serve as a model for private contractors,

- litigate the issues after careful preparation,
- contractually limit the impact of the Eichleay formula impacts, and
- contractually establish an alternate method of fixing home office overhead claim costs.

Specific conclusions are:

(1) The best long term solution may come from the first approach. As was discussed and highlighted in this report, the leading case in this concern is *Capital Electric Co. v. U.S.* [729 F2d 743, 746-747 (C.A.F.C. 1984)] where the residing judge directly urged Congress to get involved.

(2) The best short term solution may be contractually establishing an acceptable alternative to the traditional Eichleay or situation specific modified Eichleay formula methods. Currently, litigation involves both parties presenting self-supporting justification, proof and evidence as to why the Eichleay formula is not appropriate to both parties. They must either provide an authoritative alternate method of calculation or establish that home office overhead compensation is not appropriate in that case. However, if "a" formula were already well established in the areas of jurisdiction, a monumental task of Goliath proportions would be accomplished. If there is not binding precedent at the court in question, then the task may still be of mammoth proportions; resulting in expert testimony regarding formula deficiencies and alternatives available. As seen by the case law, this is the general rule rather than the exception.

(3) Provide and make available better training and knowledge within existing time and budget constraints to construction contract administration and

management personnel within NAVFACENGCOM. This is accomplished through current armed services training courses in construction administration as well as applicable training methods utilized in the construction industry that are cost effective, pertinent to contract administration, and capable of being implemented in a timely and productive manner.

CHAPTER VII

RECOMMENDATIONS

To help improve the awareness and knowledge level of the Naval Facilities Engineering Command (NAVFACENGCOM) contract administration personnel involving Eichleay unabsorbed home office overhead situations, Resident Officer in Charge of Construction (ROICC) field offices and Engineering Field Divisions (EFDs)/Engineering Field Activities (EFAs) should:

- Assess the knowledge level of project managers and construction administration personnel regarding unabsorbed home office overhead annually through survey or personnel interview. Personnel requiring improvement can utilize the Naval Facilities Contracts Training Center (NFCTC), Naval School for Civil Engineer Corps Officers (CECOS), and the U.S. Army's Logistic Management College (ALMC) for courses to fulfill their training needs.

- Ensure, through survey, personnel interview, and formal correspondence that construction administration personnel understand the theory of unabsorbed home office overhead and how to calculate contractor's requests for equitable adjustment regarding unabsorbed home office overhead correctly.

- Ensure, in the same manner, that construction administration personnel understand that there are elements of condition that must be met as well as allowable and non allowable construction contract overhead elements within the overhead pool in order for the Eichleay formula method to be appropriate for the given situation.

- **Ensure that construction administration personnel understand that there are alternative methods of calculating a contractor's request for equitable adjustment regarding unabsorbed home office overhead such as the percentage method, situation specific modified Eichleay method, as well as advance agreement methods.**

- **Ensure that all construction administration courses are filled to capacity. Project managers and engineers who have not received training in construction contract administration and management should have top priority, with more skilled and knowledgeable personnel filling the remainder of the seats for refreshment purposes.**

- Maximize construction contract administration and management personnel attendance of short duration courses, correspondence courses, and equivalency exams whenever possible. These are efficient and cost effective training opportunities available if known to the member.

- Utilize in-house talent and knowledge to establish construction contract administration management training programs for project managers and engineers, as well as officers who are in charge of construction functions.

The contract administration personnel in Resident Officer in Charge of Construction (ROICC) field offices and Engineering Field Divisions (EFDs)/Engineering Field Activities (EFAs) should identify seasoned personnel who are knowledgeable in unabsorbed home office overhead situation skills to instruct training classes and short duration sessions in-house. They can obtain

copies of CECOS, NFCTC, and ALMC instructor guides to tailor classes for specific training needs and desires.

- Establish a testing program at the CECOS, NFCTC, and ALMC training centers to pretest potential construction administration and management students; thus identifying students who require the training and measure the quality of the skills and knowledge they learned at the school if the same test is given after graduation.

Construction Contract Training Centers should:

- Evaluate the quantity and quality of construction administration and management training personnel receive in their courses. The evaluation should initially include a curriculum review of all contract administration and management courses. Construction Contract Training Centers should also review their method of course evaluation to ensure learning took place equally between all courses. This can be accomplished through pre- and post-testing students. If all courses have identical concerns of construction contract administration and management, the knowledge level of each trainee can be evaluated and tracked through time and provide valuable course improvement concerns.

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APPENDIX A

ACRONYMS

ALMC	-	United States Army Logistics Management College
ASBCA	-	Armed Services Board of Contract Appeals
BCA	-	Board of Contract Appeals
CEC	-	Civil Engineer Corps
CO	-	Commanding Officer
CO	-	Contracting Officer
DCAA	-	Defense Contracting Audit Agency
DFARS	-	Department of Defense Federal Acquisition Regulation Supplement
EFA	-	Engineering Field Activity
EFD	-	Engineering Field Division
FAR	-	Federal Acquisition Regulation
GS	-	General Service
GSA	-	General Service Administration
GSBCA	-	General Services Board of Contract Appeals
NAVFAC	-	Naval Facilities
NAVFACENGCOM-		Naval Facilities Engineering Command
NCTC	-	Naval Contracts Training Center
P-68	-	Naval Facilities Engineering Command Construction Administration Manual Publication No. 68
PWC	-	Public Works Center
PWD	-	Public Works Department
REA	-	Request for Equitable Adjustment
ROICC	-	Resident Officer in Charge of Construction
SF	-	Standard Form
VABCA	-	Veterans Administration Board of Contract Appeals

APPENDIX B

FAR PART 31 - CONTRACT COST PRINCIPLES AND PROCEDURES

PART 31

CONTRACT COST PRINCIPLES AND PROCEDURES

31.000 Scope of part.

This part contains cost principles and procedures for (a) the pricing of contracts, subcontracts, and modifications to contracts and subcontracts whenever cost analysis is performed (see 15.805-3) and (b) the determination, negotiation, or allowance of costs when required by a contract clause.

31.001 Definitions.

"Accrued benefit cost method" means an actuarial cost method under which units of benefit are assigned to each cost accounting period and are valued as they accrue; i.e., based on the services performed by each employee in the period involved. The measure of normal cost under this method for each cost accounting period is the present value of the units of benefit deemed to be credited to employees for service in that period. The measure of the actuarial liability at a plan's inception date is the present value of the units of benefit credited to employees for service prior to that date. (This method is also known as the unit credit cost method.)

"Accumulating costs" means collecting cost data in an organized manner, such as through a system of accounts.

"Actual cash value" means the cost of replacing damaged property with other property of like kind and quality in the physical condition of the property immediately before the damage.

"Actual costs," as used in this part (other than Subpart 31.6), means amounts determined on the basis of costs incurred, as distinguished from forecasted costs. Actual costs include standard costs properly adjusted for applicable variances.

"Actuarial assumption" means a prediction of future conditions affecting pension costs; e.g., mortality rate, employee turnover, compensation levels, pension fund earnings, and changes in values of pension funds assets.

"Actuarial cost method" means a technique which uses actuarial assumptions to measure the present value of future pension benefits and pension fund administrative expenses, and which assigns the cost of such benefits and expenses to cost accounting periods.

"Actuarial gain and loss" means the effect on pension cost resulting from differences between actuarial assumptions and actual experience.

"Actuarial liability" means pension cost attributable, under the actuarial cost method in use, to years before the date of a particular actuarial valuation. As of such date, the actuarial liability represents the excess of the present value of the future benefits and administrative expenses over the present value of future contributions, for the normal cost for all plan participants and beneficiaries. The excess of the actuarial liability over the value of the assets of a pension plan is the unfunded actuarial liability.

"Actuarial valuation" means the determination, as of a specified date, of the normal cost, actuarial liability, value of the assets of a pension fund, and other relevant values for the pension plan.

"Allocate" means to assign an item of cost, or a group of items of cost, to one or more cost objectives. This term includes both direct assignment of cost and the reassignment of a share from an indirect cost pool.

"Automatic data processing equipment (ADPE)," as used in this part means:

(a) Digital and analog computer components and systems, irrespective of type of use, size, capacity, or price;

(b) All peripheral, auxiliary, and accessorial equipment used in support of digital and/or analog computers, either cable connected, or "self standing," and whether selected or acquired with the computers or separately;

(c) Punched card machines (PCM) and systems used in conjunction with or independently of digital or analog computers; and

(d) Digital and analog terminal and conversion equipment that is acquired solely or primarily for use with a system which employs a computer or punched card machines.

"Business unit" means any segment of an organization, or an entire business organization which is not divided into segments.

"Compensated personal absence" means any absence from work for reasons such as illness, vacation, holidays, jury duty, military training, or personal activities for which an employer pays compensation directly to an employee in accordance with a plan or custom of the employer.

"Cost input" means the cost, except general and administrative (G&A) expenses, which for contract costing purposes is allocable to the production of goods and services during a cost accounting period.

"Cost objective," as used in this part (other than Subpart 31.6), means a function, organizational subdivision, contract, or other work unit for which cost data are desired and for which provision is made to accumulate and measure the cost of processes, products, jobs, capitalized projects, etc.

"Cost of capital committed to facilities" means an imputed cost determined by applying a cost of money rate to facilities capital.

"Deferred compensation" means an award made by an employer to compensate an employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods before the date of the receipt of compensation by the employee. This definition shall not include the amount of year end accruals for salaries, wages, or bonuses that are to be paid within a reasonable period of time after the end of a cost accounting period.

"Defined-benefit pension plan" means a pension plan in which the benefits to be paid, or the basis for determining such benefits, are established in advance and the contributions are intended to provide the stated benefits.

"Defined-contribution pension plan" means a pension plan in which the contributions to be made are established in advance and the benefits are determined thereby.

"Directly associated cost" means any cost which is generated solely as a result of the incurrence of another cost, and which would not have been incurred had the other cost not been incurred.

"Estimating costs" means the process of forecasting a future result in terms of cost, based upon information available at the time.

"Expressly unallowable cost" means a particular item or type of cost which, under the express provisions of an applicable law, regulation, or contract, is specifically named and stated to be unallowable.

"Facilities capital" means the net book value of tangible capital assets and of those intangible capital assets that are subject to amortization.

"Final cost objective," as used in this part (other than Subparts 31.3 and 31.6), means a cost objective that has allocated to it both direct and indirect costs and, in the contractor's accumulation system, is one of the final accumulation points.

"Fiscal year" as used in this part, means the accounting period for which annual financial statements are regularly prepared, generally a period of 12 months, 52 weeks, or 53 weeks.

"General and administrative (G&A) expense" means any management, financial, and other expense which is incurred by or allocated to a business unit and which is for the general management and administration of the business unit as a whole. G&A expense does not include those management expenses whose beneficial or causal relationship to cost objectives can be more directly measured by a base other than a cost input base representing the total activity of a business unit during a cost accounting period.

"Home office" means an office responsible for directing or managing two or more, but not necessarily all, segments of an organization. It typically establishes policy for, and provides guidance to, the segments in their operations. It usually performs management, supervisory, or administrative functions, and may also perform service functions in support of the operations of the various segments. An organization which has intermediate levels, such as groups, may have several home offices which report to a common home office. An intermediate organization may be both a segment and a home office.

"Immediate-gain actuarial cost method" means any of the several actuarial cost methods under which actuarial gains and losses are included as part of the unfunded actuarial liability of the pension plan, rather than as part of the normal cost of the plan.

"Independent research and development (IR&D) cost" means the cost of effort which is neither sponsored by a grant, nor required in performing a contract, and which falls within any of the following four areas: (a) basic research, (b) applied research, (c) development, and (d) systems and other concept formulation studies.

"Indirect cost pools," as used in this part (other than Subparts 31.3 and 31.6), means groupings of incurred costs identified with two or more cost objectives but not identified specifically with any final cost objective.

"Insurance administration expenses" means the contractor's costs of administering an insurance program; e.g., the costs of operating an insurance or risk-management department, processing claims, actuarial fees, and service fees paid to insurance companies, trustees, or technical consultants.

"Intangible capital asset" means an asset that has no physical substance, has more than minimal value, and is expected to be held by an enterprise for continued use or possession beyond the current accounting period for the benefits it yields.

"Labor cost at standard" means a preestablished measure of the labor element of cost, computed by multiplying labor-rate standard by labor-time standard.

"Labor-rate standard" means a preestablished measure, expressed in monetary terms, of the price of labor.

"Labor-time standard" means a preestablished measure, expressed in temporal terms, of the quantity of labor.

"Material cost at standard" means a preestablished measure of the material elements of cost, computed by multiplying material-price standard by material-quantity standard.

"Material-price standard" means a preestablished measure, expressed in monetary terms, of the price of material.

(Next page is 31-7)

SUBPART 31.2—CONTRACTS WITH COMMERCIAL ORGANIZATIONS

31.201 General.

31.201-1 Composition of total cost.

The total cost of a contract is the sum of the allowable direct and indirect costs allocable to the contract, incurred or to be incurred, less any allocable credits, plus any allocable cost of money pursuant to 31.205-10. In ascertaining what constitutes a cost, any generally accepted method of determining or estimating costs that is equitable and is consistently applied may be used, including standard costs properly adjusted for applicable variances. See 31.201-2(b) and (c) for Cost Accounting Standards (CAS) requirements.

31.201-2 Determining allowability.

(a) The factors to be considered in determining whether a cost is allowable include the following:

(1) Reasonableness.

(2) Allocability.

(3) Standards promulgated by the CAS Board, if applicable; otherwise, generally accepted accounting

principles and practices appropriate to the particular circumstances.

(4) Terms of the contract.

(5) Any limitations set forth in this subpart.

(b) Certain cost principles in this subpart incorporate the measurement, assignment, and allocability rules of selected CAS and limit the allowability of costs to the amounts determined using the criteria in those selected standards. Only those CAS or portions of standards specifically made applicable by the cost principles in this subpart are mandatory unless the contract is CAS-covered (see Part 30). Business units that are not otherwise subject to these standards under a CAS clause are subject to the selected standards only for the purpose of determining allowability of costs on Government contracts. Including the selected standards in the cost principles does not subject the business unit to any other CAS rules and regulations. The applicability of the CAS rules and regulations is determined by the CAS clause, if any, in the contract and the requirements of the standards themselves.

(c) When contractor accounting practices are inconsistent with this Subpart 31.2, costs resulting from such inconsistent practices shall not be allowed in excess of the amount that would have resulted from using practices consistent with this subpart.

31.201-3 Determining reasonableness.

(a) A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. Reasonableness of specific costs must be examined with particular care in connection with firms or their separate divisions that may not be subject to effective competitive restraints. No presumption of reasonableness shall be attached to the incurrence of costs by a contractor. If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable.

(b) What is reasonable depends upon a variety of considerations and circumstances, including—

(1) Whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the contractor's business or the contract performance;

(2) Generally accepted sound business practices, arm's length bargaining, and Federal and State laws and regulations;

(3) The contractor's responsibilities to the Government, other customers, the owners of the business, employees, and the public at large; and

(4) Any significant deviations from the contractor's established practices.

31.201-4 Determining allocability.

A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Subject to the foregoing, a cost is allocable to a Government contract if it—

(a) Is incurred specifically for the contract;

(b) Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or

(c) Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.

31.201-5 Credits.

The applicable portion of any income, rebate, allowance, or other credit relating to any allowable cost and received by or accruing to the contractor shall be credited to the Government either as a cost reduction or by cash refund.

31.201-6 Accounting for unallowable costs.

(a) Costs that are expressly unallowable or mutually agreed to be unallowable, including mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract. A directly associated cost is any cost which is generated solely as a result of incurring another cost, and which would not have been incurred had the other cost not been incurred. When an unallowable cost is incurred, its directly associated costs are also unallowable.

(b) Costs which specifically become designated as unallowable or as unallowable directly associated costs of unallowable costs as a result of a written decision furnished by a contracting officer shall be identified if included in or used in computing any billing, claim, or proposal applicable to a Government contract. This identification requirement applies also to any costs incurred for the same purpose under like circumstances as the costs specifically identified as unallowable under either this paragraph or paragraph (a) above.

(c) The detail and depth of records required as backup support for proposals, billings, or claims shall be that which is adequate to establish and maintain visibility of identified unallowable costs, including directly associated costs. Unallowable costs involved in determining rates used for standard costs, or for indirect cost proposals or billing, need be identified only at the time rates are proposed, established, revised, or adjusted. These requirements may be satisfied by any form of cost identification which is adequate for purposes of contract cost determination and verification.

(d) If a directly associated cost is included in a cost pool which is allocated over a base that includes the unallowable cost with which it is associated, the directly associated cost shall remain in the cost pool. Since the unallowable costs will attract their allocable share of costs from the cost pool, no further action is required to assure disallowance of the directly associated costs. In all other cases, the directly associated costs, if material in amount, must be purged from the cost pool as unallowable costs.

(e)(1) In determining the materiality of a directly associated cost, consideration should be given to the significance of (i) the actual dollar amount, (ii) the cumulative effect of all directly associated costs in a cost pool, or (iii) the ultimate effect on the cost of Government contracts.

(2) Salary expenses of employees who participate in activities that generate unallowable costs shall be treated as directly associated costs to the extent of the time spent on the proscribed activity, provided the costs are material in accordance with subparagraph (e)(1) above (except when such salary expenses are, themselves, unallowable). The time spent in proscribed activities should be compared to total time spent on company activities to determine if the costs are material. Time spent by employees outside the normal working hours should not be considered except when it is evident that an employee engages so frequently in company activities during periods outside normal working hours as to indicate that such activities are a part of the employee's regular duties.

(3) When a selected item of cost under 31.205 provides that directly associated costs be unallowable, it is intended that such directly associated costs be unallowable only if determined to be material in amount in accordance with the criteria provided in subparagraphs (e)(1) and (e)(2) above, except in those situations where allowance of any of the directly associated costs involved would be considered to be contrary to public policy.

31.201-7 Construction and architect-engineer contracts.

Specific principles and procedures for evaluating and determining costs in connection with contracts and subcontracts for construction, and architect-engineer contracts related to construction projects, are in 31.105. The applicability of these principles and procedures is set forth in 31.000 and 31.100.

31.202 Direct costs.

(a) A direct cost is any cost that can be identified specifically with a particular final cost objective. No final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose in like circumstances have been included in any indirect cost pool to be allocated to that or any other final cost objective. Costs identified specifically with the contract are direct costs of the contract and are to be charged directly to the contract. All costs specifically identified with other final cost objectives of the contractor are direct costs of those cost objectives and are not to be charged to the contract directly or indirectly.

(b) For reasons of practicality, any direct cost of minor dollar amount may be treated as an indirect cost if the accounting treatment—

(1) Is consistently applied to all final cost objectives; and

(2) Produces substantially the same results as treating the cost as a direct cost.

31.203 Indirect costs.

(a) An indirect cost is any cost not directly identified with a single, final cost objective, but identified with two or more final cost objectives or an intermediate cost objective. It is not subject to treatment as a direct cost. After direct costs have been determined and charged directly to the contract or other work, indirect costs are those remaining to be allocated to the several cost objectives. An indirect cost shall not be allocated to a final cost objective if other costs incurred for the same purpose in like circumstances have been included as a direct cost of that or any other final cost objective.

(b) Indirect costs shall be accumulated by logical cost groupings with due consideration of the reasons for incurring such costs. Each grouping should be determined so as to permit distribution of the grouping on the basis of the benefits accruing to the several cost objectives. Commonly, manufacturing overhead, selling expenses, and general and administrative (G&A) expenses are separately grouped. Similarly, the particular case may require subdivision of these groupings, e.g., building occupancy costs might be separable from those of personnel administration within the manufacturing overhead group. This necessitates selecting a distribution base common to all cost objectives to which the grouping is to be allocated. The base should be selected so as to permit allocation of the grouping on the basis of the benefits accruing to the several cost objectives. When substantially the same results can be achieved through less precise methods, the number and composition of cost groupings should be governed by practical considerations and should not unduly complicate the allocation.

(c) Once an appropriate base for distributing indirect costs has been accepted, it shall not be fragmented by removing individual elements. All items properly includable in an indirect cost base should bear a pro rata share of indirect costs irrespective of their acceptance as Government contract costs. For example, when a cost input base is used for the distribution of G&A costs, all items that would properly be part of the cost input base, whether allowable or unallowable, shall be included in the base and bear their pro rata share of G&A costs.

(d) The contractor's method of allocating indirect costs shall be in accordance with standards promulgated by the CAS Board, if applicable to the contract; otherwise, the method shall be in accordance with generally accepted accounting principles which are consistently applied. The method may require examination when—

(1) Substantial differences occur between the cost patterns of work under the contract and the contractor's other work;

(2) Significant changes occur in the nature of the business, the extent of subcontracting, fixed-asset improvement programs, inventories, the volume of sales and production, manufacturing processes, the contractor's products, or other relevant circumstances; or

(3) Indirect cost groupings developed for a contractor's primary location are applied to offsite locations. Separate cost groupings for costs allocable to offsite locations may be necessary to permit equitable distribution of costs on the basis of the benefits accruing to the several cost objectives.

(e) A base period for allocating indirect costs is the cost accounting period during which such costs are incurred and accumulated for distribution to work performed in that period. The criteria and guidance in 30.406 for selecting the cost accounting periods to be used in allocating indirect costs are incorporated herein for application to contracts subject to full CAS coverage. For contracts subject to modified CAS coverage and for non-CAS-covered contracts, the base period for allocating indirect costs will normally be the contractor's fiscal year. But a shorter period may be appropriate (1) for contracts in which performance involves only a minor portion of the fiscal year, or (2) when it is general practice in the industry to use a shorter period. When a contract is performed over an extended period, as many base periods shall be used as are required to represent the period of contract performance.

(f) Special care should be exercised in applying the principles of paragraphs (b), (c), and (d) above when Government-owned contractor-operated (GOCO) plants are involved. The distribution of corporate, division, or branch office G&A expenses to such plants operating with little or no dependence on corporate administrative activities may require more precise cost groupings, detailed accounts screening, and carefully developed distribution bases.

31.204 Application of principles and procedures.

(a) Costs shall be allowed to the extent they are reasonable, allocable, and determined to be allowable under 31.201, 31.202, 31.203, and 31.205. These criteria apply to all of the selected items that follow, even if particular guidance is provided for certain items for emphasis or clarity.

(b) Costs incurred as reimbursements or payments to a subcontractor under a cost-reimbursement, fixed-price incentive, or price redeterminable type subcontract of any tier above the first firm-fixed-price subcontract or fixed-price subcontract with economic price adjustment provisions are allowable to the extent that allowance is consistent with the appropriate subpart of this Part 31 applicable to the subcontract involved. Costs incurred as payments under firm-fixed-price subcontracts or fixed-price subcontracts with economic price adjustment provisions or modifications thereto, when cost analysis was performed under 15.805-3, shall be allowable only to the extent that the price was negotiated in accordance with 31.102.

(c) Section 31.205 does not cover every element of cost. Failure to include any item of cost does not imply that it is either allowable or unallowable. The determination of allowability shall be based on the principles and standards in this subpart and the treatment of similar or related selected items. When more than one subsection in 31.205 is relevant to a contractor cost, the cost shall be apportioned among the applicable subsections, and the determination of allowability of each portion shall be based on the guidance contained in the applicable subsection. When a cost, to which more than one subsection in 31.205 is relevant, cannot be apportioned, the determination of allowability shall be based on the guidance contained in the subsection that most specifically deals with, or best captures the essential nature of, the cost at issue.

31.205 Selected costs.

31.205-1 Public relations and advertising costs.

(a) "Public relations" means all functions and activities dedicated to—

(1) Maintaining, protecting, and enhancing the image of a concern or its products; or

(2) Maintaining or promoting reciprocal understanding and favorable relations with the public at large, or any segment of the public. The term public relations includes activities associated with areas such as advertising, customer relations, etc.

(b) "Advertising" means the use of media to promote the sale of products or services and to accomplish the activities referred to in paragraph (d) of this subsection, regardless of the medium employed, when the advertiser has control over the form and content of what will appear, the media in which it will appear, and when it will appear. Advertising media include but are not limited to conventions, exhibits, free goods, samples, magazines, newspapers, trade papers, direct mail, dealer cards, window displays, outdoor advertising, radio, and television.

(c) Public relations and advertising costs include the costs of media time and space, purchased services performed by outside organizations, as well as the applicable portion of salaries, travel, and fringe benefits of employees engaged in the functions and activities identified in paragraphs (a) and (b) of this subsection.

(d) The only advertising costs that are allowable are those specifically required by contract, or that arise from requirements of Government contracts and that are exclusively for—

(1) Recruiting personnel required for performing contractual obligations, when considered in conjunction with all other recruitment costs (but see 31.205-34);

(2) Acquiring scarce items for contract performance; or

(3) Disposing of scrap or surplus materials acquired for contract performance.

Costs of this nature, if incurred for more than one Government contract or both Government work and other work of the contractor, are allowable to the extent that the principles in 31.201-3, 31.201-4, and 31.203 are observed.

(e) Allowable public relations costs include the following:

(1) Costs specifically required by contract.

(2) Costs of—

(i) Responding to inquiries on company policies and activities;

(ii) Communicating with the public, press, stockholders, creditors, and customers; and

(iii) Conducting general liaison with news media and Government public relations officers, to the extent that such activities are limited to communication and liaison necessary to keep the public informed on matters of public concern such as notice of contract awards, plant closings or openings, employee layoffs or rehires, financial information, etc.

(3) Costs of participation in community service activities (e.g., blood bank drives, charity drives, savings bond drives, disaster assistance, etc.).

(4) Costs of plant tours and open houses (but see subparagraph (f)(5) of this subsection).

(5) Costs of keel laying, ship launching, commissioning, and roll-out ceremonies, to the extent specifically provided for by contract.

(f) Unallowable public relations and advertising costs include the following:

(1) All advertising costs other than those specified in paragraph (d) of this subsection.

(2) Costs of air shows and other special events, such as conventions and trade shows, including—

(i) Costs of displays, demonstrations, and exhibits;

(ii) Costs of meeting rooms, hospitality suites, and other special facilities used in conjunction with shows and other special events; and

(iii) Salaries and wages of employees engaged in setting up and displaying exhibits, making demonstrations, and providing briefings.

(3) Costs of sponsoring meetings, symposia, seminars, and other special events when the principal purpose of the event is other than dissemination of technical information or stimulation of production.

(4) Costs of ceremonies such as corporate celebrations and new product announcements.

(5) Costs of promotional material, motion pictures, videotapes, brochures, handouts, magazines, and other media that are designed to call favorable attention to the contractor and its activities (but see 31.205-13(a), Employee morale, health, welfare, food service, and dormitory costs and credits; 31.205-21, Labor relations costs; 31.205-43(c), Trade, business, technical, and professional activity costs; and 31.205-44, Training and education costs).

(6) Costs of souvenirs, models, imprinted clothing, buttons, and other mementos provided to customers or the public.

(7) Costs of memberships in civic and community organizations.

(8) All public relations costs, other than those specified in paragraph (e) of this subsection, whose primary purpose is to promote the sale of products or services by stimulating interest in a product or product line (except for those costs made allowable under 31.205-38(c)), or by disseminating messages calling favorable attention to the contractor for purposes of enhancing the company image to sell the company's products or services. Nothing in this subparagraph (f)(8) modifies the express unallowability of costs listed in subparagraphs (f)(2) through (f)(7). The purpose of this subparagraph is to provide criteria for determining whether costs not specifically identified should be unallowable.

(g) Notwithstanding the provisions of paragraph (d) and subparagraph (f)(2) of this subsection, reasonable costs incurred to promote American aerospace exports at domestic and international exhibits, such as air shows, trade shows, and conventions, are allowable. Such reasonable costs include transportation of the aircraft, aerospace parts and equipment, and other associated support cost. However, such allowable costs shall not include the cost of entertainment, hospitality suites or chalets, advertising media other than exhibits, and other costs not necessary to establish, operate or maintain an exhibit, display, or demonstration. This paragraph applies so long as Section 8062 of Pub. L. 100-202, or a similar provision in a subsequent act, is in effect.

(h) Costs made specifically unallowable under this subsection 31.205-1 are not made allowable under subsections of Subpart 31.2 such as 31.205-13, Employee morale, health, welfare, food service, and dormitory costs and credits; 31.205-22, Legislative lobbying costs; 31.205-34, Recruitment costs; 31.205-38, Selling costs; 31.205-43, Trade, business, technical, and professional activity costs; or 31.205-44, Training and education costs. Conversely, costs that are specifically unallowable under these and other subsections of Subpart 31.2 are not made allowable under this subsection.

31.205-2 Automatic data processing equipment leasing costs.

(a) This subsection applies to all contractor-leased automatic data processing equipment (ADPE), as defined in 31.001 (except as components of an end item to be delivered to the Government), acquired under operating leases, as defined in Statement of Financial Accounting Standard No. 13 (FAS-13), Accounting for Leases, issued by the Financial Accounting Standards Board. Compliance with 31.205-11(m) requires that

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ADPE acquired by means of capital leases, as defined in FAS-13, shall be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges or over the leased life as amortization charges as appropriate. Allowability of costs related to contractor-owned ADPE is governed by other requirements of this subpart.

(b) (1) If the contractor leases ADPE but cannot demonstrate, on the basis of facts existent at the time of the decision to lease or continue leasing and documented in accordance with paragraph (d) below, that leasing will result in less cost to the Government over the anticipated useful life (see paragraph (c) below), then rental costs are allowable only up to the amount that would be allowed had the contractor purchased the ADPE.

(2) The costs of leasing ADPE are allowable only to the extent that the contractor can annually demonstrate in accordance with paragraph (d) below (whether or not the term of lease is renewed or otherwise extended) that these costs meet the following criteria:

(i) The costs are reasonable and necessary for the conduct of the contractor's business in light of factors such as the contractor's requirements for ADPE, costs of comparable facilities, the various types of leases available, and the terms of the rental agreement.

(ii) The costs do not give rise to a material equity in the facilities (such as an option to renew or purchase at a bargain rental or price other than that normally given to industry at large) but represent charges only for the current use of the equipment, including incidental service costs such as maintenance, insurance, and applicable taxes.

(iii) The contracting officer's approval was obtained for the leasing arrangement (see subparagraph (d)(3) below) when the total cost of leasing—

(A) The ADPE is to be allocated to one or more Government contracts which require negotiating or determining costs, or

(B) ADPE in a single plant, division, or cost center exceeds $500,000 a year and 50 percent or more of the total leasing cost is to be allocated to one or more Government contracts which require negotiating or determining costs.

(3) Rental costs under a sale and leaseback arrangement are allowable only up to the amount that would have been allowed had the contractor retained title to the ADPE.

(4) Allowable rental costs of ADPE leased from any division, subsidiary, or organization under a common control are limited to the cost of ownership (excluding interest or other costs unallowable under this Subpart 31.2 and including the cost of money (see 31.205-10)). When there is an established practice of leasing the same or similar equipment to unaffiliated lessees, rental costs shall be allowed in accordance with subparagraphs (b)(1) and (2) above, except that the purchase price and costs of ownership shall be determined under 31.205-26(e).

(c) (1) An estimate of the anticipated useful life of the ADPE may represent the application life (utility in a given function), technological life (utility before becoming obsolete in whole or in part), or physical life (utility before wearing out) depending upon the facts and circumstances and the particular facilities involved. Each case must be evaluated individually. In estimating anticipated useful life, the contractor may use the application life if it can be demonstrated that the ADPE has utility only in a given function and the duration of the function can be determined. Technological life may be used if the contractor can demonstrate that existing ADPE must be replaced because of—

(i) Specific program objectives or contract requirements cannot be accomplished with the existing ADPE;

(ii) Cost reductions that will produce identifiable savings in production or overhead costs;

(iii) Increase in workload volume that cannot be accomplished efficiently by modifying or augmenting existing ADPE; or

(iv) Consistent pattern of capacity operation (2 ⅓-3 shifts) on existing ADPE.

(2) Technological advances will not justify replacing existing ADPE before the end of its physical life if it will be able to satisfy future requirements or demands.

(3) In estimating the least cost to the Government for useful life, the cumulative costs that would be allowed if the contractor owned the ADPE should be compared with cumulative costs that would be allowed under any of the various types of leasing arrangements available. For the purpose of this comparison, the costs of ADPE exclude interest or other unallowable costs pursuant to this Subpart 31.2; they include but are not limited to the costs of operation, maintenance, insurance, depreciation, facilities capital cost of money, rental, and the cost of machine services, as applicable.

(d) (1) Except as provided in subparagraph (3) below, the contractor's justification, under paragraph (b) above, of the leasing decisions shall consist of the following supporting data, prepared before acquisition:

(i) Analysis of use of existing ADPE.

(ii) Application of the criteria in paragraph (b) above.

(iii) Specific objectives or requirements, generally in the form of a data system study and specification.

(iv) Solicitation of proposals, based on the data system specification, from qualified sources.

(v) Proposals received in response to the solicitation and reasons for selecting the equipment chosen and for the decision to lease.

(2) Except as provided in subparagraph (3) below, the contractor's annual justification, under subparagraph (b)(2) above, of the decision to retain or change existing ADPE capability and the need to continue leasing shall consist of current data as specified in subdivisions (d)(1)(i) through (iii) above.

(3) If the contractor's prospective ADPE lease cost meets the threshold in 31.205-2(b)(2)(iii) above, the contractor shall furnish data supporting the initial decision to lease (see subparagraph (b)(1) above). If the total cost of leasing ADPE in a single plant, division, or cost center exceeds $500,000 per year and 50 percent or more of the total leasing cost is allocated to Government contracts which require negotiating or determining costs, the contractor shall furnish data supporting the annual justification for retaining or changing existing ADPE capability and the need to continue leasing shall also be furnished (see subparagraph (b)(2) above).

31.205-3 Bad debts.

Bad debts, including actual or estimated losses arising from uncollectible accounts receivable due from customers and other claims, and any directly associated costs such as collection costs, and legal costs are unallowable.

31.205-4 Bonding costs.

(a) Bonding costs arise when the Government requires assurance against financial loss to itself or others by reason of the act or default of the contractor. They arise also in instances where the contractor requires similar assurance. Included are such bonds as bid, performance, payment, advance payment, infringement, and fidelity bonds.

(b) Costs of bonding required pursuant to the terms of the contract are allowable.

(c) Costs of bonding required by the contractor in the general conduct of its business are allowable to the extent that such bonding is in accordance with sound business practice and the rates and premiums are reasonable under the circumstances.

31.205-5 Civil defense costs.

(a) Civil defense costs are those incurred in planning for, and protecting life and property against, the possible effects of enemy attack. Costs of civil defense measures (including costs in excess of normal plant protection costs, first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions, and other approved civil defense measures) undertaken on the contractor's premises pursuant to suggestions or requirements of civil defense authorities are allowable when allocated to all work of the contractor.

(b) Costs of capital assets acquired for civil defense purposes are allowable through depreciation (see 31.205-11).

(c) Contributions to local civil defense funds and projects are unallowable.

31.205-6 Compensation for personal services.

(a) *General.* Compensation for personal services includes all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor during the period of contract performance (except as otherwise provided for severance pay costs in paragraph (g) below and for pension costs in paragraph (j) below). It includes, but is not limited to, salaries; wages; directors' and executive committee members' fees; bonuses (including stock bonuses); incentive awards; employee stock options, stock appreciation rights, and stock ownership plans; employee insurance; fringe benefits; contributions to pension, annuity, and management employee incentive compensation plans; and allowances for off-site pay, incentive pay, location allowances, hardship pay, severance pay, and cost of living differential. Compensation for personal services is allowable subject to the following general criteria and additional requirements contained in other parts of this cost principle:

(1) Compensation for personal services must be for work performed by the employee in the current year and must not represent a retroactive adjustment of prior years' salaries or wages (but see 31.205-6(g), (h), (j), (k), and (m) below).

(2) The compensation in total must be reasonable for the work performed; however, specific restrictions on individual compensation elements must be observed where they are prescribed.

(3) The compensation must be based upon and conform to the terms and conditions of the contractor's established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make the payment.

(4) No presumption of allowability will exist where the contractor introduces major revisions of existing compensation plans or new plans and the contractor—

(i) Has not notified the cognizant ACO of the changes either before their implementation or within a reasonable period after their implementation, and

(ii) Has not provided the Government, either before implementation or within a reasonable period after it, an opportunity to review the allowability of the changes.

(5) Costs that are unallowable under other paragraphs of this Subpart 31.2 shall not be allowable under this subsection 31.205-6 solely on the basis that they constitute compensation for personal services. (See 31.205-34(c).)

(b) *Reasonableness.* (1) The compensation for personal services paid or accrued to each employee must be reasonable for the work performed. Compensation will be considered reasonable if each of the allowable elements making up the employee's compensation package is reasonable. In determining the reasonableness of individual elements for particular employees or classes of employees, consideration should be given to all potentially relevant facts. Facts which may be relevant include general conformity with the compensation practices of other firms of the same size, the compensation practices of other firms in the same industry, the compensation practices of other firms in the same geographic area, the compensation practices of firms engaged in predominantly non-Government work, and the cost of comparable services obtainable from outside sources. While all of the above factors, as well as any other relevant ones, should be considered, their relative significance will vary according to circumstances. For example, in the case of secretarial salaries, conformity with the compensation paid by other firms in the same geographic area would likely be a more significant criterion than conformity with the compensation paid by other firms in the same industry wherever located. In administering this principle, it is recognized that not every compensation case need be subjected in detail to the above or other tests. The tests need be applied only when a general review reveals amounts or types of compensation that appear unreasonable or unjustified. Based on an initial review of the facts, contracting officers or their representatives may challenge the reasonableness of any individual element or the sum of the individual elements of compensation paid or accrued to particular employees or classes of employees. In such cases, there is no presumption of reasonableness and, upon challenge, the contractor must demonstrate the reasonableness of the compensation item in question. In doing so, the contractor may introduce, and the contracting officer will consider, not only any circumstances surrounding the compensation item challenged, but also the magnitude of other compensation elements which may be lower than would be considered reasonable in themselves. For example, a contractor, if challenged on the amount of base salaries for management, could counter by showing lower than normal end-of-year management bonuses. However, the contractor's right to introduce offsetting compensation elements into consideration is subject to the following limitations:

(i) Offsets will be considered only between the allowable elements of an employee's (or a class of employees') compensation package. For example, excessive management salaries cannot be offset against lower than normal secretarial salaries.

(ii) Offsets will be considered only between the allowable portion of the following compensation elements of employees or classes of employees:

(A) Wages and salaries.

(B) Incentive bonuses.

(C) Deferred compensation.

(D) Pension and savings plan benefits.

(E) Health insurance benefits.

(F) Life insurance benefits.

(G) Compensated personal absence benefits.

However, any of the above elements or portions thereof, whose amount is not measurable, shall not be introduced or considered as an offset item.

(iii) In considering offsets, the magnitude of the compensation elements in question must be taken into account. An executive bonus that is excessive by $100,000 is not fully offset by a base salary that is low by only $25,000. In determining the magnitude of compensation elements, the timing of receipt by the employee must be considered. For example, a bonus of $100,000 in the current period will be considered as of greater value than a deferred compensation arrangement to make the same payment in some future period.

(2) Compensation costs under certain conditions give rise to the need for special consideration. Among such conditions are the following:

(i) Compensation to (A) owners of closely held corporations, partners, sole proprietors, or members of their immediate families, or (B) persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise. Determination should be made that salaries are reasonable for the personal services rendered rather than being a distribution of profits. Compensation in lieu of salary for services rendered by partners and sole proprietors will be allowed to the extent that it is reasonable and does not constitute a distribution of profits. For closely held corporations, compensation costs covered by this subdivision shall not be recognized in amounts exceeding those costs that are deductible as compensation under the Internal Revenue Code and regulations under it.

(ii) Any change in a contractor's compensation policy that results in a substantial increase in the contractor's level of compensation, particularly when it was concurrent with an increase in the ratio of Government contracts to other business, or any change in the treatment of allowability of specific types of compensation due to changes in Government policy. Contracting officers or their representatives should normally challenge increased costs where major revisions of existing compensation plans or new plans are introduced by the contractor, and the contractor —

(A) Has not notified the cognizant ACO of the changes either before their implementation or within a reasonable period after their implementation; and

(B) Has not provided the Government, either before implementation or within a reasonable

period after it, an opportunity to review the reasonableness of the changes.

(iii) The contractor's business is such that its compensation levels are not subject to the restraints that normally occur in the conduct of competitive business.

(iv) The contractor incurs costs for compensation in excess of the amounts which are deductible under the Internal Revenue Code and regulations issued under it.

(c) *Labor-management agreements.* Nothwithstanding any other requirements of this subsection 31.205-6, costs of compensation are not allowable to the extent that they result from provisions of labor-management agreements that, as applied to work in performing Government contracts, are determined to be unreasonable because they are either unwarranted by the character and circumstances of the work or discriminatory against the Government. The application of the provisions of a labor-management agreement designed to apply to a given set of circumstances and conditions of employment (e.g., work involving extremely hazardous activities or work not requiring recurrent use of overtime) is unwarranted when applied to a Government contract involving significantly different circumstances and conditions of employment (e.g., work involving less hazardous activities or work continually requiring use of overtime). It is discriminatory against the Government if it results in employee compensation (in whatever form or name) in excess of that being paid for similar non-Government work under comparable circumstances. Disallowance of costs will not be made under this paragraph (c) unless—

(1) The contractor has been permitted an opportunity to justify the costs; and

(2) Due consideration has been given to whether unusual conditions pertain to Government contract work, imposing burdens, hardships, or hazards on the contractor's employees, for which compensation that might otherwise appear unreasonable is required to attract and hold necessary personnel.

(d) *Salaries and wages.* Salaries and wages for current services include gross compensation paid to employees in the form of cash, stock (see subparagraph (f)(2) below regarding valuation), products, or services, and are allowable.

(e) *Domestic and foreign differential pay.* (1) When personal services are performed in a foreign country, compensation may also include a differential that may properly consider all expenses associated with foreign employment such as housing, cost of living adjustments, transportation, bonuses, additional Federal, State, local or foreign income taxes resulting from foreign assignment, and other related expenses.

(2) Although the additional taxes in subparagraph (1) above may be considered in establishing foreign overseas differential, any increased compensation calculated directly on the basis of an employee's specific increase in income taxes is unallowable. Differential allowances for additional Federal, State, or local income taxes resulting from domestic assignments are unallowable.

(f) *Bonuses and incentive compensation.* (1) Incentive compensation for management employees, cash bonuses, suggestion awards, safety awards, and incentive compensation based on production, cost reduction, or efficient performance are allowable provided the awards are paid or accrued under an agreement entered into in good faith between the contractor and the employees before the services are rendered or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment and the basis for the award is supported.

(2) When the costs of bonuses and incentive compensation are paid in the stock of the contractor or of an affiliate, the following additional restrictions apply:

(i) Valuation placed on the stock shall be the fair market value on the measurement date (i.e., the first date the number of shares awarded is known) determined upon the most objective basis available; and

(ii) Accruals for the cost of stock before issuing the stock to the employees shall be subject to adjustment according to the possibilities that the employees will not receive the stock and that their interest in the accruals will be forfeited.

(3) When the bonus and incentive compensation payments are deferred, the costs are subject to the requirements of subparagraph (f)(1) above and of paragraph (k) below.

(g) *Severance pay.* (1) Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages by contractors to workers whose employment is being involuntarily terminated. Payments for early retirement incentive plans are covered in subparagraph (j)(6) below.

(2) Severance pay to be allowable must meet the general allowability criteria in subdivision (g)(2)(i) below, and, depending upon whether the severance is normal or abnormal, criteria in subdivision (g)(2)(ii) for normal severance pay or subdivision (g)(2)(iii) for abnormal severance pay also apply.

(i) Severance pay is allowable only to the extent that, in each case, it is required by (A) law, (B) employer-employee agreement, (C) established policy that constitutes, in effect, an implied agreement on the contractor's part, or (D) circumstances of the particular employment. Payments made in the event of employment with a replacement contractor where continuity of employment with credit for prior length of service is preserved under substantially equal conditions of employ-

ment, or continued employment by the contractor at another facility, subsidiary, affiliate, or parent company of the contractor are not severance pay and are unallowable. Severance payments, or amounts paid in lieu thereof, are not allowable when paid to employees in addition to early or normal retirement payments.

(ii) Actual normal turnover severance payments shall be allocated to all work performed in the contractor's plant, or where the contractor provides for accrual of pay for normal severances, that method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period and if amounts accrued are allocated to all work performed in the contractor's plant.

(iii) Abnormal or mass severance pay is of such a conjectural nature that measurement of costs by means of an accrual will not achieve equity to both parties. Thus, accruals for this purpose are not allowable. However, the Government recognizes its obligation to participate, to the extent of its fair share, in any specific payment. Thus, allowability will be considered on a case-by-case basis.

(h) *Backpay.* (1) *Backpay resulting from violations of Federal labor laws or the Civil Rights Act of 1964.* Backpay may result from a negotiated settlement, order, or court decree that resolves a violation of Federal labor laws or the Civil Rights Act of 1964. Such backpay falls into two categories: one requiring the contractor to pay employees additional compensation for work performed for which they were underpaid, and the other resulting from other violations, such as when the employee was improperly discharged, discriminated against, or other circumstances for which the backpay was not additional compensation for work performed. Backpay resulting from underpaid work is compensation for the work performed and is allowable. All other backpay resulting from violation of Federal labor laws or the Civil Rights Act of 1964 is unallowable.

(2) *Other backpay.* Backpay may also result from payments to union employees (union and non-union) for the difference in their past and current wage rates for working without a contract or labor agreement during labor management negotiations. Such backpay is allowable. Backpay to nonunion employees based upon results of union agreement negotiations is allowable only if (i) a formal agreement or understanding exists between management and the employees concerning these payments, or (ii) an established policy or practice exists and is followed by the contractor so consistently as to imply, in effect, an agreement to make such payment.

(i) *Stock options, stock appreciation rights, phantom stock plans, and junior stock conversions.*

(1) The cost of stock options awarded to employees to purchase stock of the contractor or of an affiliate will be treated as deferred compensation and must comply with the requirements of paragraph (k) of this subsection. The allowable cost of stock options is limited to the difference between the option price and the market price on the first date on which the option price and the number of shares are known. Accordingly, when the stock option price is equal to or greater than the market price on that date, then no costs are allowable for contract costing purposes.

(2) Stock appreciation rights are rights granted to employees by contractors to receive the increase in value, or appreciation, of company stock even though the employee neither purchases the stock nor receives title to it. Stock appreciation rights will be treated as deferred compensation and must comply with the requirements of paragraph (k) of this subsection. The allowable cost of stock appreciation rights is limited to the difference between the stock-appreciation-right base price from which appreciation will be measured and the market price on the first date on which both the number of shares and the stock-appreciation-right base price are known. Accordingly, when the stock-appreciation-right base price is equal to or greater than the market price on that date, then no costs are allowable for contract costing purposes.

(3) In phantom-stock-type plans, contractors assign or attribute contingent shares of stock to employees as if the employees own the stock, even though the employees neither purchase the stock nor receive title to it. Under these plans, an employee's account may be increased by the equivalent of dividends paid and any appreciation in the market price of the stock over the price of the stock on the first date on which the number of shares awarded is known. Such increases in employee accounts for dividend equivalents and market price appreciation are unallowable.

(4) Junior stock is a class of equity stock that (i) is sold to employees at a price below that of the contractor's common stock, (ii) carries reduced dividend voting rights, and (iii) is convertible to common stock upon the attainment of specified corporate goals. Costs associated with the conversion of junior stock into common stock are not allowable, whether or not they are accounted for as compensation costs.

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(j) *Pension costs.* (1) A pension plan is a deferred compensation plan that is established and maintained by one or more employers to provide systematically for paying benefits to plan participants after their retirement, provided that the benefits are paid for life or are payable for life at the option of the employee. Additional benefits such as permanent and total disability and death payments and survivorship payments to beneficiaries of deceased employees may be treated as pension costs, provided the benefits are an integral part of the pension plan and meet all the criteria pertaining to pension costs.

(2) Pension plans are normally segregated into two types of plans: defined benefit or defined contribution pension plans. The cost of all defined benefit pension plans shall be measured, allocated, and accounted for in compliance with the provisions of 30.412, Composition and Measurement of Pension Costs, and 30.413, Adjustment and Allocation of Pension Cost. The costs of all defined contribution pension plans shall be measured, allocated, and accounted for in accordance with the provisions of 30.412. Pension costs are allowable subject to the referenced standards and the cost limitations and exclusions set forth below in this subparagraph and in subparagraphs (j)(3), (4), (5), (6), and (7) below.

(i) To be allowable in the current year, pension costs must be funded by the time set for filing the Federal income tax return or any extension thereof. Pension costs assigned to the current year, but not funded by the tax return time, shall not be allowable in any subsequent year.

(ii) Pension payments must be reasonable in amount and be paid pursuant to (A) an agreement entered into in good faith between the contractor and employees before the work or services are performed and (B) the terms and conditions of the established plan. The cost of changes in pension plans which are discriminatory to the Government or are not intended to be applied consistently for all employees under similar circumstances in the future are not allowable.

(iii) Except as provided for early retirement benefits in subparagraph (j)(6) below, one-time-only pension supplements not available to all participants of the basic plan are not allowable as pension costs unless the supplemental benefits represent a separate pension plan and the benefits are payable for life at the option of the employee.

(iv) Increases in payments to previously retired plan participants covering cost-of-living adjustments are allowable if paid in accordance with a policy or practice consistently followed.

(3) *Defined benefit pension plans.* This subparagraph covers pension plans in which the benefits to be paid or the basis for determining such benefits are established in advance and the contributions are intended to provide the stated benefits. The cost limitations and exclusions pertaining to defined benefit plans are as follows:

(i) Normal costs of pension plans not funded in the year incurred, and all other components of pension costs (see 30.412.40(a)(1)) assignable to the current accounting period but not funded during it, shall not be allowable in subsequent years (except that a payment made to a fund by the time set for filing the Federal income tax return or any extension thereof is considered to have been made during such taxable year). However, any part of a pension cost that is computed for a cost accounting period that is deferred pursuant to a waiver granted under the provisions of the Employee Retirement Income Security Act of 1974 (ERISA) (see 30.412.50(c)(3)), will be allowable in those future accounting periods in which the funding does occur. The allowability of these deferred contributions will be limited to the amounts that would have been allowed had the funding occurred in the year the costs would have been assigned except for the waiver.

(ii) Any amount paid or funded before the time it becomes assignable and allowable shall be applied to future years, in order of time, as if actually paid and deductible in those years. The interest earned on such premature funding, based on the valuation rate of return, may be excluded from future years' computations of pension costs in accordance with 30.412.50(a)(7).

(iii) Increased pension costs caused by delay in funding beyond 30 days after each quarter of the year to which they are assignable are unallowable. If a composite rate is used for allocating pension costs between the segments of a company and if, because of differences in the timing of the funding by the segments, an inequity exists, allowable pension costs for each segment will be limited to that particular segment's calculation of pension costs as provided for in 30.413.50(c)(5). Determination of unallowable costs shall be made in accordance with the actuarial method used in calculating pension costs.

(iv) Allowability of the cost of indemnifying the Pension Benefit Guaranty Corporation (PBGC) under ERISA Section 4062 or 4064 arising from terminating an employee deferred compensation plan will be considered on a case-by-case basis; provided that if insurance was required by the PBGC under ERISA Section 4023, it was so obtained and the indemnification payment is not recoverable under the insurance. Consideration under the foregoing circumstances will be primarily for the purpose of appraising the extent to which the indemnification payment is allocable to

Government work. If a beneficial or other equitable relationship exists, the Government will participate, despite the requirements of 31.205-19(a)(3) and (b), in the indemnification payment to the extent of its fair share.

(4) *Defined contribution pension plans.* This subparagraph covers those pension plans in which the contributions to be made are established in advance and the level of benefits is determined by the contributions made. It also covers profit sharing, savings plans, and other such plans provided the plans fall within the definition of a pension plan in subparagraph (j)(1) above.

(i) The pension cost assignable to a cost accounting period is the net contribution required to be made for that period after taking into account dividends and other credits, where applicable. However, any portion of pension cost computed for a cost accounting period that is deferred pursuant to a waiver granted under the provisions of ERISA (see 30.412.50(c)(3)) will be allowable in those future accounting periods when the funding does occur. The allowability of these deferred contributions will be limited to the amounts that would have been allowed had the funding been made in the year the costs would have been assigned except for the waiver.

(ii) Any amount paid or funded to the trust before the time it becomes assignable and allowable shall be applied to future years, in order of time, as if actually paid and deductible in such years.

(iii) The provisions of subdivision (j)(3)(iv) above concerning payments to PBGC apply to defined contribution plans.

(5) *Pension plans using pay-as-you-go methods.* A pension plan using pay-as-you-go methods is a plan in which the contractor recognizes pension cost only when benefits are paid to retired employees or their beneficiaries. Regardless of whether the payment of pension benefits contribution can or cannot be compelled, allowable costs for these types of plans shall not exceed an amount computed as follows:

(i) Compute, by using an actuarial cost method, the plan's actuarial liability for benefits earned by plan participants. This entire liability is always unfunded for a pay-as-you-go plan.

(ii) Compute a level amount which, including an interest equivalent, would amortize the unfunded actuarial liability over a period of no less than 10 or more than 40 years from the inception of the liability.

(iii) Compute, by using an actuarial cost method, a normal cost for the period.

(iv) The sum of (ii) and (iii) above represents the amount of pension costs assignable to the current period. This amount, however, is limited to the amount paid in the year.

(v) For purposes of determining contract cost where a pay-as-you-go plan is initiated as either a supplemental plan or an additional but separate plan to a basic funded plan, the plans will be treated as one plan; e.g., the actuarial cost method, past service amortization period, etc., of the basic plan will be used on the supplemental or additional pay-as-you-go plan in determining the proper costs assignable to the current period. Any costs in excess of those determined by using the actuarial cost method and assumptions of the basic plan are unallowable. However, where assumptions for salary progressions, mortality rates of the participants, and so forth are significantly different, the assumptions used for the basic and supplemental plan may be different.

(vi) The requirements of subdivisions (j)(3)(i) through (iv) above are also applicable to pay-as-you-go plans.

(6) *Early retirement incentive plans.* An early retirement incentive plan is a plan under which employees receive a bonus or incentive, over and above the requirement of the basic pension plan, to retire early. These plans normally are not applicable to all participants of the basic plan and do not represent life income settlements, and as such would not qualify as pension costs. However, for contract costing purposes, early retirement incentive payments are allow-

able subject to the pension cost criteria contained in subdivisions (j)(3)(i) through (iv) provided—

(i) The costs are accounted for and allocated in accordance with the contractor's system of accounting for pension costs (see subdivision (j)(5)(v) above for supplemental pension benefits);

(ii) The payments are made in accordance with the terms and conditions of the contractor's plan;

(iii) The plan is applied only to active employees. The cost of extending the plan to employees who retired or were terminated before the adoption of the plan is unallowable; and

(iv) The total of the incentive payments to any employee may not exceed the amount of the employee's annual salary for the previous fiscal year before the employee's retirement.

(7) *Employee stock ownership plans (ESOP).* (i) An ESOP is an individual stock bonus plan designed specifically to invest in the stock of the employer corporation. The contractor's contributions to an Employee Stock Ownership Trust (ESOT) may be in the form of cash, stock, or property. Costs of ESOP's are allowable subject to the following conditions:

(A) Contributions by the contractor in any one year may not exceed 15 percent (25 percent when a money purchase plan is included) of salaries and wages of employees participating in the plan in any particular year.

(B) The contribution rate (ratio of contribution to salaries and wages of participating employees) may not exceed the last approved contribution rate except when approved by the contracting officer based upon justification provided by the contractor. When no contribution was made in the previous year for an existing ESOP, or when a new ESOP is first established, and the contractor proposes to make a contribution in the current year, the contribution rate shall be subject to the contracting officer's approval.

(C) When a plan or agreement exists wherein the liability for the contribution can be compelled for a specific year, the expense associated with that liability is assignable only to that period. Any portion of the contribution not funded by the time set for filing of the Federal income tax return for that year or any extension thereof shall not be allowable in subsequent years.

(D) When a plan or agreement exists wherein the liability for the contribution cannot be compelled, the amount contributed for any year is assignable to that year provided the amount is funded by the time set for filing of the Federal income tax return for that year.

(E) When the contribution is in the form of stock, the value of the stock contribution shall be limited to the fair market value of the stock on the date that title is effectively transferred to the trust. Cash contributions shall be allowable only when the contractor furnishes evidence satisfactory to the contracting officer demonstrating that stock purchases by the ESOT are or will be at a fair market price; e.g., makes arrangements with the trust permitting the contracting officer to examine purchases of stock by the trust to determine that prices paid are at fair market value. When excessive prices are paid, the amount of the excess will be credited to the same indirect cost pools that were charged for the ESOP contributions in the year in which the stock purchase occurs. However, when the trust purchases the stock with borrowed funds which will be repaid over a period of years by cash contributions from the contractor to the trust, the excess price over fair market value shall be credited to the indirect cost pools pro rata over the period of years during which the contractor contributes the cash used by the trust to repay the loan. When the fair market value of unissued stock or stock of a closely held corporation is not readily determinable, the valuation will be made on a case-by-case basis taking into consideration the guidelines for valuation used by the IRS.

(ii) Amounts contributed to an ESOP arising from either (A) an additional investment tax credit (see 1975 Tax Reduction Act—TRASOP's); or (B) a payroll-based tax credit (see Economic Recovery Tax Act of 1981) are unallowable.

(iii) The requirements of subdivision (j)(3)(ii) above are applicable to Employee Stock Ownership Plans.

(k) *Deferred compensation.* (1) Deferred compensation is an award given by an employer to compensate an employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods before the date of receipt of compensation by the employee. Deferred compensation does not include the amount of year-end accruals for salaries, wages, or bonuses that are paid within a reasonable period of time after the end of a cost accounting period. Subject to 31.205-6(a), deferred awards are allowable when they are based on current or future services. Awards made in periods subsequent to the period when the work being remunerated was performed are not allowable.

(2) The costs of deferred awards shall be measured, allocated, and accounted for in compliance with the provisions of 30.415, Accounting for the Cost of Deferred Compensation.

(3) Deferred compensation payments to employees under awards made before the effective date of 30.415 are allowable to the extent they would have been allowable under prior acquisition regulations.

(l) *Compensation incidental to business acquisitions.* The following costs are unallowable:

(1) Payments to employees under agreements in which they receive special compensation, in excess of the contractor's normal severance pay practice, if their employment terminates following a change in the management control over, or ownership of, the contractor or a substantial portion of its assets.

(2) Payments to employees under plans introduced in connection with a change (whether actual or prospective) in the management control over, or ownership of, the contractor or a substantial portion of its assets in which those employees receive special compensation, which is contingent upon the employee remaining with the contractor for a specified period of time.

(m) *Fringe benefits.* (1) Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Fringe benefits include, but are not limited to, the cost of vacations, sick leave, holidays, military leave, employee insurance, and supplemental unemployment benefit plans. Except as provided elsewhere in Subpart 31.2, the costs of fringe benefits are allowable to the extent that they are reasonable and are required by law, employer-employee agreement, or an established policy of the contractor.

(2) That portion of the cost of company-furnished automobiles that relates to personal use by employees (including transportation to and from work) is unallowable regardless of whether the cost is reported as taxable income to the employees (see 31.205-46(f)).

(n) *Employee rebate and purchase discount plans.* Rebates and purchase discounts, in whatever form, granted to employees on products or services produced by the contractor or affiliates are unallowable.

31.205-7 Contingencies.

(a) "Contingency," as used in this subpart, means a possible future event or condition arising from presently known or unknown causes, the outcome of which is indeterminable at the present time.

(b) Costs for contingencies are generally unallowable for historical costing purposes because such costing deals with costs incurred and recorded on the contractor's books. However, in some cases, as for example, terminations, a contingency factor may be recognized when it is applicable to a past period to give recognition to minor unsettled factors in the interest of expediting settlement.

(c) In connection with estimates of future costs, contingencies fall into two categories:

(1) Those that may arise from presently known and existing conditions, the effects of which are foreseeable within reasonable limits of accuracy; e.g., anticipated costs of rejects and defective work. Contingencies of this category are to be included in the estimates of future costs so as to provide the best estimate of performance cost.

(2) Those that may arise from presently known or unknown conditions, the effect of which cannot be measured so precisely as to provide equitable results to the contractor and to the Government; e.g., results of pending litigation. Contingencies of this category are to be excluded from cost estimates under the several items of cost, but should be disclosed separately (including the basis upon which the contingency is computed) to facilitate the negotiation of appropriate contractual coverage. (See, for example, 31.205-6(g), 31.205-19, and 31.205-24.)

31.205-8 Contributions or donations.

Contributions or donations, including cash, property and services, regardless of recipient, are unallowable, except as provided in 31.205-1(e)(3).

31.205-9 Reserved.

31.205-10 Cost of money.

(a) *Facilities capital cost of money.* (1) *General.* (i) Facilities capital cost of money (cost of capital committed to facilities) is an imputed cost determined by applying a cost-of-money rate to facilities capital employed in contract performance. A cost-of-money rate is uniformly imputed to all contractors (see subdivision (ii) below). Capital employed is determined without regard to whether its source is equity or borrowed capital. The resulting cost of money is not a form of interest on borrowings (see 31.205-20).

(ii) 30.414, Cost of Money as an Element of the Cost of Facilities Capital, establishes criteria for measuring and allocating, as an element of contract cost, the cost of capital committed to facilities. Cost-of-money factors are developed on Form CASB-CMF, broken down by overhead pool at the business unit, using (A) business-unit facilities capital data, (B) overhead allocation base data, and (C) the cost-of-money rate, which is based on interest rates specified by the Secretary of the Treasury under 50 U.S.C. App. 1215(b)(2).

(2) *Allowability.* Whether or not the contract is otherwise subject to CAS, facilities capital cost of money is allowable if—

(i) The contractor's capital investment is measured, allocated to contracts, and costed in accordance with 30.414;

(ii) The contractor maintains adequate records to demonstrate compliance with this standard; and

(iii) The estimated facilities capital cost of money is specifically identified or proposed in cost proposals relating to the contract under which this cost is to be claimed.

(3) *Accounting.* The facilities capital cost of money need not be entered on the contractor's books of account. However, the contractor shall (i) make a

memorandum entry of the cost and (ii) maintain, in a manner that permits audit and verification, all relevant schedules, cost data, and other data necessary to support the entry fully.

(4) *Payment.* Facilities capital cost of money that is (i) allowable under subparagraph (2) above, and (ii) calculated, allocated, and documented in accordance with this cost principle shall be an "incurred cost" for reimbursement purposes under applicable cost-reimbursement contracts and for progress payment purposes under fixed-price contracts.

(5) The cost of money resulting from including good will (however represented) in the facilities capital employed base is unallowable.

(b) *Cost of money as an element of the cost of capital assets under construction.* (1) *General.* (i) Cost of money as an element of the cost of capital assets under construction is an imputed cost determined by applying a cost-of-money rate to the investment in tangible and intangible capital assets while they are being constructed, fabricated, or developed for a contractor's own use. Capital employed is determined without regard to whether its source is equity or borrowed capital. The resulting cost of money is not a form of interest on borrowing (see 31.205-20).

(ii) 30.417, Cost of Money as an Element of the Cost of Capital Assets Under Construction, establishes criteria for measuring and allocating, as an element of contract cost, the cost of capital

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committed to capital assets under construction, fabrication, or development.

(2) *Allowability.* (i) Whether or not the contract is otherwise subject to CAS, and except as specified in subdivision (ii) below, the cost of money for capital assets under construction, fabrication, or development is allowable if—

(A) The cost of money is calculated, allocated to contracts, and costed in accordance with 30.417;

(B) The contractor maintains adequate records to demonstrate compliance with this standard; and

(C) The cost of money for tangible capital assets is included in the capitalized cost that provides the basis for allowable depreciation costs, or, in the case of intangible capital assets, the cost of money is included in the cost of those assets for which amortization costs are allowable.

(ii) Actual interest cost in lieu of the calculated imputed cost of money for capital assets under construction, fabrication, or development is unallowable.

(3) *Accounting.* The cost of money for capital assets under construction need not be entered on the contractor's books of account. However, the contractor shall (i) make a memorandum entry of the cost and (ii) maintain, in a manner that permits audit and verification, all relevant schedules, cost data, and other data necessary to support the entry fully.

(4) *Payment.* The cost of money for capital assets under construction that is allowable under subparagraph (2) above of this cost principle shall be an "incurred cost" for reimbursement purposes under applicable cost-reimbursement contracts and for progress payment purposes under fixed-price contracts.

31.205-11 Depreciation.

(a) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life refers to the prospective period of economic usefulness in a particular contractor's operations as distinguished from physical life; it is evidenced by the actual or estimated retirement and replacement practice of the contractor.

(b) Contractors having contracts subject to 30.409, Depreciation of Tangible Capital Assets, must adhere to the requirement of that standard for all fully CAS-covered contracts and may elect to adopt the standard for all other contracts. All requirements of 30.409 are applicable if the election is made, and its requirements supersede any conflicting requirements of this cost principle. Once electing to adopt 30.409 for all contracts, contractors must continue to follow it until notification of final acceptance of all deliverable items on all open negotiated Government contracts. Paragraphs (c) through (e) below apply to contracts to which 30.409 is not applied.

(c) Normal depreciation on a contractor's plant, equipment, and other capital facilities is an allowable contract cost, if the contractor is able to demonstrate that it is reasonable and allocable (but see paragraph (i) below).

(d) Depreciation shall be considered reasonable if the contractor follows policies and procedures that are—

(1) Consistent with those followed in the same cost center for business other than Government;

(2) Reflected in the contractor's books of accounts and financial statements; and

(3) Both used and acceptable for Federal income tax purposes.

(e) When the depreciation reflected on a contractor's books of accounts and financial statements differs from that used and acceptable for Federal income tax purposes, reimbursement shall be based on the asset cost amortized over the estimated useful life of the property using depreciation methods (straight line, sum of the years' digits, etc.) acceptable for income tax purposes. Allowable depreciation shall not exceed the amounts used for book and statement purposes and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same cost center on non-Government business.

(f) Depreciation for reimbursement purposes in the case of tax-exempt organizations shall be determined on the basis described in paragraph (e) immediately above.

(g) Special considerations are required for assets acquired before the effective date of this cost principle if, on that date, the undepreciated balance of these assets resulting from depreciation policies and procedures used previously for Government contracts and subcontracts is different from the undepreciated balance on the books and financial statements. The undepreciated balance for contract cost purposes shall be depreciated over the remaining life using the methods and lives followed for book purposes. The aggregate depreciation of any asset allowable after the effective date of this 31.205-11 shall not exceed the cost basis of the asset less any depreciation allowed or allowable under prior acquisition regulations.

(h) Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives in paragraph (a) above, vary with volume of production or use of multishift operations.

(i) In the case of emergency facilities covered by certificates of necessity, a contractor may elect to use normal depreciation without requesting a determination of "true depreciation," or may elect to use either

normal or "true depreciation" after a determination of "true depreciation" has been made by an Emergency Facilities Depreciation Board (EFDB). The method elected must be followed consistently thoughout the life of the emergency facility. When an election is made to use normal depreciation, the criteria in paragraphs (c), (d), (e), and (f) above shall apply for both the emergency period and the post-emergency period. When an election is made to use "true depreciation", the amount allowable as depreciation—

(1) With respect to the emergency period (five years), shall be computed in accordance with the determination of the EFDB and allocated rateably over the full five year emergency period; *provided* no other allowance is made which would duplicate the factors, such as extraordinary obsolescence, covered by the Board's determination; and

(2) After the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."

(j) No depreciation, rental, or use charge shall be allowed on property acquired at no cost from the Government by the contractor or by any division, subsidiary, or affiliate of the contractor under common control.

(k) The depreciation on any item which meets the criteria for allowance at a "price" under 31.205-26(e) may be based on that price, provided the same policies and procedures are used for costing all business of the using division, subsidiary, or organization under common control.

(l) No depreciation or rental shall be allowed on property fully depreciated by the contractor or by any division, subsidiary, or affiliate of the contractor under common control. However, a reasonable charge for using fully depreciated property may be agreed upon and allowed (but see 31.109(h)(2)). In determining the charge, consideration shall be given to cost, total estimated useful life at the time of negotiations, effect of any increased maintenance charges or decreased efficiency due to age, and the amount of depreciation previously charged to Government contracts or subcontracts.

(m) 30.404, Capitalization of Tangible Assets, applies to assets acquired by a "capital lease" as defined in Statement of Financial Accounting Standard No. 13 (FAS-13), Accounting for Leases, issued by the Financial Accounting Standards Board (FASB). Compliance with 30.404 and FAS-13 requires that such leased assets (capital leases) be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges, or over the leased life as amortization charges as appropriate. Assets whose leases are classified as capital leases under FAS-13 are subject to the requirements of 31.205-11 while assets acquired under leases classified as operating leases are subject to the requirements on rental costs in 31.205-36. The standards of financial accounting and reporting prescribed by FAS-13 are incorporated into this principle and shall govern its application, except as provided in subparagraphs (1), (2), and (3) below.

(1) Rental costs under a sale and leaseback arrangement shall be allowable up to the amount that would have been allowed had the contractor retained title to the property.

(2) Capital leases, as defined in FAS-13, for all real and personal property, between any related parties are subject to the requirements of this subparagraph 31.205-11(m). If it is determined that the terms of the lease have been significantly affected by the fact that the lessee and lessor are related, depreciation charges shall not be allowed in excess of those which would have occurred if the lease contained terms consistent with those found in a lease between unrelated parties.

(3) Assets acquired under leases that the contractor must capitalize under FAS-13 shall not be treated as purchased assets for contract purposes if the leases are covered by 31.205-36(b)(4).

31.205-12 Economic planning costs.

(a) This category includes costs of generalized long-range management planning that is concerned with the future overall development of the contractor's business and that may take into account the eventual possibility of economic dislocations or fundamental alterations in those markets in which the contractor currently does business. Economic planning costs do not include organization or reorganization costs covered by 31.205-27.

(b) Economic planning costs are allowable as indirect costs to be properly allocated.

(c) Research and development and engineering costs designed to lead to new products for sale to the general public are not allowable under this principle.

31.205-13 Employee morale, health, welfare, food service, and dormitory costs and credits.

(a) Aggregate costs incurred on activities designed to improve working conditions, employer-employee relations, employee morale, and employee performance (less income generated by these activities) are allowable, except as limited by paragraph (b) immediately below, and to the extent that the net amount is reasonable. Some examples are house publications, health clinics, recreation, employee counseling services, and food and dormitory services, which include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, living accommodations, or similar types of services for the contractor's employees at or near the contractor's facilities.

(b) Losses from operating food and dormitory services may be included as costs only if the contractor's objective is to operate such services on a break-even

basis. Losses sustained because food services or lodging accommodations are furnished without charge or at prices or rates which obviously would not be conducive to the accomplishment of the above objective are not allowable. A loss may be allowed, however, to the extent that the contractor can demonstrate that unusual circumstances exist (e.g., (1) Where the contractor must provide food or dormitory services at remote locations where adequate commercial facilities are not reasonably available, or (2) where charged but unproductive labor costs would be excessive but for the services provided or where cessation or reduction of food or dormitory operations will not otherwise yield net cost savings) such that even with efficient management, operating the services on a break-even basis would require charging inordinately high prices, or prices or rates higher than those charged by commercial establishments offering the same services in the same geographical areas. Costs of food and dormintory services shall include an allocable share of indirect expenses pertaining to these activities.

(c) When the contractor has an arrangement authorizing an employee association to provide or operate a service, such as vending machines in the contractor's plant and retain the profits, such profits shall be treated in the same manner as if the contractor were providing the service (but see paragraph (d) immediately below).

(d) Contributions by the contractor to an employee organization, including funds from vending machine receipts or similar sources, may be included as costs incurred under paragraph (a) above only to the extent that the contractor demonstrates that an equivalent amount of the costs incurred by the employee organization would be allowable if directly incurred by the contractor.

31.205-14 Entertainment costs.

Costs of amusement, diversion, social activities, and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities are unallowable (but see 31.205-1 and 31.205-13). Costs of membership in social, dining, or country clubs or other organizations having the same purposes are also unallowable, regardless of whether the cost is reported as taxable income to the employees.

31.205-15 Fines and penalties.

Costs of fines and penalties resulting from violations of, or failure of the contractor to comply with, Federal, State, local, or foreign laws and regulations, are unallowable except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer.

31.205-16 Gains and losses on disposition of depreciable property or other capital assets.

(a) Gains and losses from the sale, retirement, or other disposition (but see 31.205-19) of depreciable property shall be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included (but see paragraph (d) below).

(b) Gains and losses on disposition of tangible capital assets, including those acquired under capital leases (see 31.205-11(m), shall be considered as adjustments of depreciation costs previously recognized. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds from involuntary conversions, and its undepreciated balance. The gain recognized for contract costing purposes shall be limited to the difference between the acquisition cost (or for assets acquired under a capital lease, the value at which the leased asset is capitalized) of the asset and its undepreciated balance (except see subdivisions (c)(2)(i) or (ii) below).

(c) Special considerations apply to an involuntary conversion which occurs when a contractor's property is destroyed by events over which the owner has no control, such as fire, windstorm, flood, accident, theft, etc., and an insurance award is recovered. The following govern involuntary conversions:

(1) When there is a cash award and the converted asset is not replaced, gain or loss shall be recognized in the period of disposition. The gain recognized for contract costing purposes shall be limited to the difference between the acquistion cost of the asset and its undepreciated balance.

(2) When the converted asset is replaced, the contractor shall either—

(i) Adjust the depreciable basis of the new asset by the amount of the total realized gain or loss; or

(ii) Recognize the gain or loss in the period of disposition, in which case the Government shall participate to the same extent as outlined in subparagraph (c)(1) above.

(d) Gains and losses on the disposition of depreciable property shall not be recognized as a separate charge or credit when—

(1) Gains and losses are processed through the depreciation reserve account and reflected in the depreciation allowable under 31.205-11; or

(2) The property is exchanged as part of the purchase price of a similar item, and the gain or loss is taken into consideration in the depreciation cost basis of the new item.

(e) Gains and losses arising from mass or extraordinary sales, retirements, or other disposition shall be considered on a case-by-case basis.

(f) Gains and losses of any nature arising from the sale or exchange of capital assets other than depreciable property shall be excluded in computing contract costs.

31.205-17 Idle facilities and idle capacity costs.

(a) "Costs of idle facilities or idle capacity," as used in this subsection, means costs such as maintenance, repair, housing, rent, and other related costs; e.g., property taxes, insurance, and depreciation.

"Facilities," as used in this subsection, means plant or any portion thereof (including land integral to the operation), equipment, individually or collectively, or any

other tangible capital asset, wherever located, and whether owned or leased by the contractor.

"Idle capacity," as used in this subsection, means the unused capacity of partially used facilities. It is the difference between that which a facility could achieve under 100 percent operating time on a one-shift basis, less operating interruptions resulting from time lost for repairs, setups, unsatisfactory materials, and other normal delays, and the extent to which the facility was actually used to meet demand during the accounting period. A multiple-shift basis may be used in the calculation instead of a one-shift basis if it can be shown that this amount of usage could normally be expected for the type of facility involved.

"Idle facilities," as used in this subsection, means completely unused facilities that are excess to the contractor's current needs.

(b) The costs of idle facilities are unallowable unless the facilities—

(1) Are necessary to meet fluctuations in workload; or

(2) Were necessary when acquired and are now idle because of changes in requirements, production economies, reorganization, termination, or other causes which could not have been reasonably foreseen. (Costs of idle facilities are allowable for a reasonable period, ordinarily not to exceed 1 year, depending upon the initiative taken to use, lease, or dispose of the idle facilities (but see 31.205-42)).

(c) Costs of idle capacity are costs of doing business and are a factor in the normal fluctuations of usage or overhead rates from period to period. Such costs are allowable provided the capacity is necessary or was originally reasonable and is not the subject to reduction or elimination by subletting, renting, or sale, in accordance with sound business, economics, or security practices. Widespread idle capacity throughout an entire plant or among a group of assets having substantially the same function may be idle facilities.

(d) Any costs to be paid directly by the Government for idle facilities or idle capacity reserved for defense mobilization production shall be the subject of a separate agreement.

31.205-18 Independent research and development and bid and proposal costs.

(a) *Definitions.*

"Applied research," as used in this subsection, means that effort which (1) normally follows basic research, but may not be severable from the related basic research, (2) attempts to determine and exploit the potential of scientific discoveries or improvements in technology, materials, processes, methods, devices, or techniques, and (3) attempts to advance the state of the art. Applied research does not include efforts whose principal aim is design, development, or test of specific items or services to be considered for sale; these efforts are within the definition of the term "development," defined below.

"Basic research," as used in this subsection, means that research which is directed toward increase of knowledge in science. The primary aim of basic research is a fuller knowledge or understanding of the subject under study, rather than any practical application thereof.

"Bid and proposal (B&P) costs," as used in this subdivision, means the costs incurred in preparing, submitting, and supporting bids and proposals (whether or not solicited) on potential Government or non-Government contracts. The term does not include the costs of effort sponsored by a grant or cooperative agreement or required in contract performance.

"Company," as used in this subsection, means all divisions, subsidiaries, and affiliates of the contractor under common control.

"Development," as used in this subsection, means the systematic use, under whatever name, of scientific and technical knowledge in the design, development, test, or evaluation of a potential new product or service (or of an improvement in an existing product or service) for the purpose of meeting specific performance requirements or objectives. Development includes the functions of design engineering, prototyping, and engineering testing. Development excludes: (1) subcontracted technical effort which is for the sole purpose of developing an additional source for an existing product, or (2) development effort for manufacturing or production materials, systems, processes, methods, equipment, tools, and techniques not intended for sale.

"Independent research and development (IR&D)" means a contractor's IR&D cost that is not sponsored by, or required in performance of, a contract or grant and that consists of projects falling within the four following areas: (1) basic research, (2) applied research, (3) development, and (4) systems and other concept formulation studies. IR&D effort shall not include technical effort expended in developing and preparing technical data specifically to support submitting a bid or proposal.

"Systems and other concept formulation studies," as used in this subsection, means analyses and study efforts either related to specific IR&D efforts or directed toward identifying desirable new systems, equipments or components, or modifications and improvements to existing systems, equipments, or components.

(b) *Composition and allocation of costs.* The requirements of 30.420, Accounting for Independent Research and Development Costs and Bid and Proposal Costs, are incorporated in their entirety and shall apply as follows—

(1) *Fully-CAS-covered contracts.* Contracts that are fully-CAS-covered shall be subject to all requirements of 30.420.

(2) *Modified CAS-covered and non-CAS-covered contracts.* Contracts that are not CAS-covered or that contain terms or conditions requiring modified CAS coverage shall be subject to all requirements of 30.420 *except* 4 CFR 420.50(e)(2) and 4 CFR 420.50(f)(2), which are not then applicable. However, non-CAS covered or modified CAS-covered contracts awarded at a time the contractor has CAS-covered contracts requiring compliance with 30.420, shall be subject to all the requirements of 30.420. When the requirements of 4 CFR 420.50(e)(2) and 4 CFR 420.50(f)(2) are not applicable, the following apply:

(i) IR&D and B&P costs shall be allocated to final cost objectives on the same basis of allocation used for the G&A expense grouping of the profit center (see 31.001) in which the costs are incurred. However, when IR&D and B&P costs clearly benefit other profit centers or benefit the entire company, those costs shall be allocated through the G&A of the other profit centers or through the corporate G&A, as appropriate.

(ii) If allocations of IR&D or B&P through the G&A base do not provide equitable cost allocation, the contracting officer may approve use of a different base.

(c) *Allowability.* Except as provided in paragraph (d) below, costs for IR&D and B&P are allowable only in accordance with the following:

(1) *Companies required to negotiate advance agreements.*

(i) Any company that received payments for IR&D and B&P costs in a fiscal year, either as a prime contractor or subcontractor, exceeding $4,400,000 from Government agencies, is required to negotiate with the Government an advance agreement which establishes a ceiling for allowability of IR&D and B&P costs for the following fiscal year. This agreement is binding on all Government agencies, unless prohibited by statute. The requirements of Section 203 of Pub. L. 91-441 necessitate that the Department of Defense (DOD) be the lead negotiating agency when the contractor has received more than $4,400,000 in payments for IR&D and B&P from DOD. Computation of IR&D and B&P costs to determine whether the threshold criterion was reached shall include only recoverable IR&D and B&P costs allocated during the company's previous fiscal year to prime contracts and subcontracts for which the submission and certification of cost or pricing data were required. (Also see paragraph (b) above and 15.804.) The computation shall include full burdening pursuant to 30.420.

(ii) When a company meets the criterion in (i) above, required advance agreements may be negotiated at the corporate level and/or with those profit centers that contract directly with the Government and that in the preceding year allocated recoverable IR&D and B&P costs exceeding $550,000, including burdening, to contracts and subcontracts for which the submission and certification of cost or pricing data were required (also see paragraph (b) above and 15.804). When ceilings are negotiated for separate profit centers of the company, the allowability of IR&D and B&P costs for any center that in its previous fiscal year did not reach the $550,000 threshold may be determined in accordance with subparagraph (c)(2) below.

(iii) Ceilings are the maximum dollar amounts of total IR&D and B&P costs that will be allowable for allocation over the appropriate base for that part of the company's operation covered by an advance agreement.

(iv) No IR&D and B&P cost shall be allowable if a company fails to initiate negotiation of a required advance agreement before the end of the fiscal year for which the agreement is required.

(v) When negotiations are held with a company meeting the $4,400,000 criterion or with separate profit centers (when negotiations are held at that level under (ii) above), and if no advance agreement is reached, payment for IR&D and B&P costs shall be reduced below that which the company or profit center would have otherwise received. The amount of such reduced payment shall not exceed 75 percent of the amount which, in the opinion of the contracting officer, the company or profit center would be entitled to receive under an advance agreement. Written notification of the contracting officer's determination of a reduced amount shall be provided the contractor. In the event that an advance agreement is not reached before the end of the contractor's fiscal year for which the agreement is to apply, negotiations shall immediately be terminated, and the contracting officer shall furnish a determination of the reduced amount.

(vi) Contractors may appeal decisions of the contracting officer to reduce payment. The appeal shall be filed with the contracting officer within 30 days of receipt of the contracting officer's determination. (Also see Subpart 42.10.)

(2) *Companies not required to negotiate advance agreements.* Ceilings for allowable IR&D and B&P costs for companies not required to negotiate advance agreements in accordance with subparagraph (c)(1) above shall be established by a formula, either on a company-wide basis or by profit centers, computed as follows:

(i) Determine the ratio of IR&D/B&P costs to total sales (or other base acceptable to the contracting officer) for each of the preceding three

years and average the two highest of these ratios; this average is the IR&D/B&P historical ratio;

(ii) Compute the average annual IR&D/B&P costs (hereafter called average), using the two highest of the preceding three years;

(iii) IR&D/B&P costs for the center for the current year which are not in excess of the product of the center's actual total sales (or other accepted base) for the current year and the IR&D/B&P historical ratio computed under (i) above (hereafter called product) shall be considered allowable only to the extent the product does not exceed 120 percent of the average. If the product is less than 80 percent of the average, costs up to 80 percent of the average shall be allowable.

(iv) However, at the discretion of the contracting officer, an advance agreement may be negotiated when the contractor can demonstrate that the formula would produce a clearly inequitable cost recovery.

(d) *Deferred IR&D and B&P costs.* (1) IR&D costs that were incurred in previous accounting periods are unallowable, except when a contractor has developed a specific product at its own risk in anticipation of recovering the development costs in the sale price of the product provided that—

(i) The total amount of IR&D costs applicable to the product can be identified;

(ii) The proration of such costs to sales of the product is reasonable;

(iii) The contractor had no Government business during the time that the costs were incurred or did not allocate IR&D costs to Government contracts except to prorate the cost of developing a specific product to the sales of that product; and

(iv) No costs of current IR&D programs are allocated to Government work except to prorate the costs of developing a specific product to the sales of that product.

(2) When deferred costs are recognized, the contract (except firm-fixed-price and fixed-price with economic price adjustment) will include a specific provision setting forth the amount of deferred IR&D costs that are allocable to the contract. The negotiation memorandum will state the circumstances pertaining to the case and the reason for accepting the deferred costs.

31.205-19 Insurance and indemnification.

(a) Insurance by purchase or by self-insuring includes coverage the contractor is required to carry, or to have approved, under the terms of the contract and any other coverage the contractor maintains in connection with the general conduct of its business. Any contractor desiring to establish a program of self-insurance applicable to contracts that are not subject to 30.416, Accounting for Insurance Costs, shall comply with the self-insurance requirements of that standard as well as with Part 28 of this Regulation. However, approval of a contractor's insurance program in accordance with Part 28 does not constitute a determination as to the allowability of the program's cost. The amount of insurance costs which may be allowed is subject to the cost limitations and exclusions in the following subparagraphs.

(1) Costs of insurance required or approved, and maintained by the contractor pursuant to the contract, are allowable.

(2) Costs of insurance maintained by the contractor in connection with the general conduct of its business are allowable, subject to the following limitations:

(i) Types and extent of coverage shall follow sound business practice, and the rates and premiums must be reasonable.

(ii) Costs allowed for business interruption or other similar insurance must be limited to exclude coverage of profit.

(iii) The cost of property insurance premiums for insurance coverage in excess of the acquisition cost of the insured assets is allowable only when the contractor has a formal written policy assuring that in the event the insured property is involuntarily converted, the new asset shall be valued at the book value of the replaced asset plus or minus adjustments for differences between insurance proceeds and actual replacement cost. If the contractor does not have such a formal written policy, the cost of premiums for insurance coverage in excess of the acquisition cost of the insured asset is unallowable.

(iv) Costs of insurance for the risk of loss of or damage to Government property are allowable only to the extent that the contractor is liable for such loss or damage and such insurance does not cover loss or damage that results from willful misconduct or lack of good faith on the part of any of the contractor's directors or officers or other equivalent representatives.

(v) Contractors operating under a program of self-insurance must obtain approval of the program when required by 28.308(a).

(vi) Costs of insurance on the lives of officers, partners, or proprietors are allowable only to the extent that the insurance represents additional compensation (see 31.205-6).

(3) Actual losses are unallowable unless expressly provided for in the contract, except—

(i) Losses incurred under the nominal deductible provisions of purchased insurance, in keeping with sound business practice, are allowable for contracts not subject to 30.416 and when the contractor did not establish a self-insurance program. Such contracts are not subject to the self-insurance requirements of 30.416. For contracts subject to 30.416, and for those made subject to the self-

insurance requirements of that Standard as a result of the contractor's having established a self-insurance program (see paragraph (a) above), actual losses may be used as a basis for charges under a self-insurance program when the actual amount of losses will not differ significantly from the projected average losses for the accounting period (see 4 CFR 416.50(a)(2)(ii)). In those instances where an actual loss has occurred and the present value of the liability is determined under the provisions of 30.416-50(a)(3)(ii), the allowable cost shall be limited to an amount computed using as a discount rate the interest rate determined by the Secretary of the Treasury pursuant to 50 U.S.C. App. 1215(b)(2) in effect at the time the loss is recognized. However, the full amount of a lump-sum settlement to be paid within a year of the date of settlement is allowable.

(ii) Minor losses, such as spoilage, breakage, and disappearance of small hand tools that occur in the ordinary course of doing business and that are not covered by insurance are allowable.

(4) The cost of insurance to protect the contractor against the costs of correcting its own defects in materials or workmanship is unallowable. However, insurance costs to cover fortuitous or casualty losses resulting from defects in materials or workmanship are allowable as a normal business expense.

(5) Premiums for retroactive or backdated insurance written to cover occurred and known losses are unallowable.

(b) If purchased insurance is available, the charge for any self-insurance coverage plus insurance administration expenses shall not exceed the cost of comparable purchased insurance plus associated insurance administration expenses.

(c) Insurance provided by captive insurers (insurers owned by or under the control of the contractor) is considered self-insurance, and charges for it must comply with the self-insurance provisions of 30.416. However, if the captive insurer also sells insurance to the general public in substantial quantities and it can be demonstrated that the charge to the contractor is based on competitive market forces, the insurance will be considered purchased insurance.

(d) The allowability of premiums for insurance purchased from fronting insurance companies (insurance companies not related to the contractor but who reinsure with a captive insurer of the contractor) shall not exceed the amount (plus reasonable fronting company charges for services rendered) which the contractor would have been allowed had it insured directly with the captive insurer.

(e) Self-insurance charges for risks of catastrophic losses are not allowable (see 28.308(e)).

(f)4 The Government is obligated to indemnify the contractor only to the extent authorized by law, as expressly provided for in the contract, except as provided in paragraph (a)(3) above.

(g) Late premium payment charges related to employee deferred compensation plan insurance incurred pursuant to Section 4007 (29 U.S.C. 1307) or Section 4023 (29 U.S.C. 1323) of the Employee Retirement Income Security Act of 1974 are unallowable.

31.205-20 Interest and other financial costs.

Interest on borrowings (however represented), bond discounts, costs of financing and refinancing capital (net worth plus long-term liabilities), legal and professional fees paid in connection with preparing prospectuses, costs of preparing and issuing stock rights, and directly associated costs are unallowable except for interest assessed by State or local taxing authorities under the conditions specified in 31.205-41 (but see 31.205-28).

31.205-21 Labor relations costs.

Costs incurred in maintaining satisfactory relations between the contractor and its employees, including costs of shop stewards, labor management committees, employee publications, and other related activities, are allowable.

31.205-22 Legislative lobbying costs.

(a) Costs associated with the following activities are unallowable:

(1) Attempts to influence the outcomes of any Federal, State, or local election, referendum, initiative, or similar procedure, through in kind or cash contributions, endorsements, publicity, or similar activities;

(2) Establishing, administering, contributing to, or paying the expenses of a political party, campaign, political action committee, or other organization established for the purpose of influencing the outcomes of elections;

(3) Any attempt to influence (i) the introduction of Federal or state legislation, or (ii) the enactment or modification of any pending Federal or state legislation through communication with any member or employee of the Congress or state legislature (including efforts to influence state or local officials to engage in similar lobbying activity), or with any government official or employee in connection with a decision to sign or veto enrolled legislation;

(4) Any attempt to influence (i) the introduction of Federal or state legislation, or (ii) the enactment or modification of any pending Federal or state legislation by preparing, distributing or using publicity or propaganda, or by urging members of the general public or any segment thereof to contribute to or participate in any mass demonstration, march, rally, fund raising drive, lobbying campaign or letter writing or telephone campaign; or

(5) Legislative liasion activities, including attendance at legislative sessions or committee hearings, gathering information regarding legislation, and analyzing the effect of legislation, when such activities are carried on in support of or in knowing preparation for an effort to engage in unallowable activities.

(b) The following activities are excepted from the coverage of (a) above:

(1) Providing a technical and factual presentation of information on a topic directly related to the performance of a contract through hearing testimony, statements or letters to the Congress or a state legislature, or subdivision, member, or cognizant staff member thereof, in response to a documented request (including a Congressional Record notice requesting testimony or statements for the record at a regularly scheduled hearing) made by the recipient member, legislative body or subdivision, or a cognizant staff member thereof; provided such information is readily obtainable and can be readily put in deliverable form; and further provided that costs under this section for transportation, lodging or meals are unallowable unless incurred for the purpose of offering testimony at a regularly scheduled Congressional hearing pursuant to a written request for such presentation made by the Chairman or Ranking Minority Member of the Committee or Subcommittee conducting such hearing.

(2) Any lobbying made unallowable by (a)(3) above to influence state legislation in order to directly reduce contract cost, or to avoid material impairment of the contractor's authority to perform the contract.

(3) Any activity specifically authorized by statute to be undertaken with funds from the contract.

(c) When a contractor seeks reimbursement for indirect costs, total lobbying costs shall be separately identified in the indirect cost rate proposal, and thereafter treated as other unallowable activity costs.

(d) Contractors shall submit as part of their annual indirect cost rate proposals a certification that the requirements and standards of this subsection have been complied with.

(e) Contractors shall maintain adequate records to demonstrate that the certification of costs as being allowable or unallowable pursuant to this subsection complies with the requirements of this subsection.

(f) Time logs, calendars, or similar records shall not be required to be created for purposes of complying with this subsection during any particular calendar month when—

(1) The employee engages in lobbying (as defined in (a) and (b) of this subsection) 25 percent of the employee's compensated hours of employment during that calendar month; and

(2) Within the preceding 5-year period, the organization has not materially misstated allowable or unallowable costs of any nature, including legislative lobbying costs. When conditions of subparagraphs (f)(1) and (2) of this subsection are met, contractors are not required to establish records to support the allowability of claimed costs in addition to records already required or maintained. Also, when conditions of subparagraphs (f)(1) and (2) of this subsection are met, the absence of time logs, calendars, or similar records will not serve as a basis for disallowing costs by contesting estimates of lobbying time spent by employees during a calendar month.

(g) Existing procedures should be utilized to resolve in advance any significant questions or disagreements concerning the interpretation or application of this subsection.

31.205-23 Losses on other contracts.

An excess of costs over income under any other contract (including the contractor's contributed portion under cost-sharing contracts) is unallowable.

31.205-24 Maintenance and repair costs.

(a) Costs necessary for the upkeep of property (including Government property, unless otherwise provided for) that neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are to be treated as follows (but see 31.205-11):

(1) Normal maintenance and repair costs are allowable.

(2) Extraordinary maintenance and repair costs are allowable, provided those costs are allocated to the applicable periods for purposes of determining contract costs (but see 31.109).

(b) Expenditures for plant and equipment, including rehabilitation which should be capitalized and subject to depreciation, according to generally accepted accounting principles as applied under the contractor's established policy or, when applicable, according to 30.404, Capitalization of Tangible Assets, are allowable only on a depreciation basis.

31.205-25 Manufacturing and production engineering costs.

(a) The costs of manufacturing and production engineering effort as described in (1) through (4) below are all allowable:

(1) Developing and deploying new or improved materials, systems, processes, methods, equipment, tools and techniques that are or are expected to be used in producing products or services;

(2) Developing and deploying pilot production lines;

(3) Improving current production functions, such as plant layout, production scheduling and control, methods and job analysis, equipment capabilities and capacities, inspection techniques, and tooling analysis (including tooling design and application improvements); and

(4) Material and manufacturing producibility analysis for production suitability and to optimize manufacturing processes, methods, and techniques.

(b) This cost principle does not cover:

(1) Basic and applied research effort (as defined in 31.205-18(a)) related to new technology, materials, systems, processes, methods, equipment, tools and techniques. Such technical effort is governed by 31.205-18, Independent research and development costs; and

(2) Development effort for manufacturing or production materials, systems, processes, methods,

equipment, tools and techniques that are intended for sale is also governed by 31.205-18.

(c) Where manufacturing or production development costs are capitalized or required to be capitalized under the contractor's capitalization policies, allowable cost will be determined in accordance with the requirements of 31.205-11, Depreciation.

31.205-26 Material costs.

(a) Material costs include the costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. In computing material costs, consideration shall be given to reasonable overruns, spoilage, or defective work (unless otherwise provided in any contract provision relating to inspecting and correcting defective work). These costs are allowable, subject to the requirements of paragraphs (b) through (e) below.

(b) Costs of material shall be adjusted for income and other credits, including available trade discounts, refunds, rebates, allowances, and cash discounts, and credits for scrap, salvage, and material returned to vendors. Such income and other credits shall either be credited directly to the cost of the material or be allocated as a credit to indirect costs. When the contractor can demonstrate that failure to take cash discounts was reasonable, lost discounts need not be credited.

(c) Reasonable adjustments arising from differences between periodic physical inventories and book inventories may be included in arriving at costs; *provided*, such adjustments relate to the period of contract performance.

(d) When materials are purchased specifically for and are identifiable solely with performance under a contract, the actual purchase cost of those materials should be charged to the contract. If material is issued from stores, any generally recognized method of pricing such material is acceptable if that method is consistently applied and the results are equitable. When estimates of future material costs are required, current market price or anticipated acquisition cost may be used, but the basis of pricing must be disclosed.

(e) Allowance for all materials, supplies, and services that are sold or transferred between any divisions, subsidiaries, or affiliates of the contractor under a common control shall be on the basis of cost incurred in accordance with this subpart. However, allowance may be at a price when it is the established practice of the transferring organization to price interorganizational transfers at other than cost for commercial work of the contractor or any division, subsidiary, or affiliate of the contractor under a common control, and when the price—

(1) Is or is based on an "established catalog or market price of commercial items sold in substantial quantities to the general public" in accordance with 15.804; or

(2) Is the result of "adequate price competition" in accordance with 15.804 and is the price at which an award was made to the affiliated organization after obtaining quotations on an equal basis from such organization and one or more outside sources that produce the item or its equivalent in significant quantity.

(3) Provided, that in either subparagraph (1) or (2) above—

(i) The price is not in excess of the transferor's current sales price to its most favored customer (including any division, subsidiary or affiliate of

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the contractor under a common control) for a like quantity under comparable conditions; and

(ii) The contracting officer has not determined the price to be unreasonable.

(f) The price determined in accordance with subparagraph (e)(1) above should be adjusted to reflect the quantities being acquired and may be adjusted to reflect actual cost of any modifications necessary because of contract requirements.

31.205-27 Organization costs.

(a) Except as provided in paragraph (b) of this subsection, expenditures in connection with (1) planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, (2) resisting or planning to resist the reorganization of the corporate structure of a business or a change in the controlling interest in the ownership of a business, and (3) raising capital (net worth plus long-term liabilities), are unallowable. Such expenditures include but are not limited to incorporation fees and costs of attorneys, accountants, brokers, promoters and organizers, management consultants and investment counselors, whether or not employees of the contractor. Unallowable "reorganization" costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in alterations in the rights and interests of security holders, whether or not additional capital is raised.

(b) The cost of activities primarily intended to provide compensation will not be considered organizational costs subject to this subsection, but will be governed by 31.205-6. These activities include acquiring stock for (1) executive bonuses, (2) employee savings plans, and (3) employee stock ownership plans.

31.205-28 Other business expenses.

The following types of recurring costs are allowable when allocated on an equitable basis:

(a) Registry and transfer charges resulting from changes in ownership of securities issued by the contractor.

(b) Cost of shareholders' meetings.

(c) Normal proxy solicitations.

(d) Preparing and publishing reports to shareholders.

(e) Preparing and submitting required reports and forms to taxing and other regulatory bodies.

(f) Incidental costs of directors' and committee meetings.

(g) Other similar costs.

31.205-29 Plant protection costs.

Costs of items such as (a) wages, uniforms, and equipment of personnel engaged in plant protection, (b) depreciation on plant protection capital assets, and (c) necessary expenses to comply with military requirements, are allowable.

31.205-30 Patent costs.

(a) The following patent costs are allowable to the extent that they are incurred as requirements of a Government contract (but see 31.205-33):

(1) Costs of preparing invention disclosures, reports, and other documents.

(2) Costs for searching the art to the extent necessary to make the invention disclosures.

(3) Other costs in connection with the filing and prosecution of a United States patent application where title or royalty-free license is to be conveyed to the Government.

(b) General counseling services relating to patent matters, such as advice on patent laws, regulations, clauses, and employee agreements, are allowable (but see 31.205-33).

(c) Other than those for general counseling services, patent costs not required by the contract are unallowable. (See also 31.205-37.)

31.205-31 Plant reconversion costs.

Plant reconversion costs are those incurred in restoring or rehabilitating the contractor's facilities to approximately the same condition existing immediately before the start of the Government contract, fair wear and tear excepted. Reconversion costs are unallowable except for the cost of removing Government property and the restoration or rehabilitation costs caused by such removal. However, in special circumstances where equity so dictates, additional costs may be allowed to the extent agreed upon before costs are incurred. Care should be exercised to avoid duplication through allowance as contingencies, additional profit or fee, or in other contracts.

31.205-32 Precontract costs.

Precontract costs are those incurred before the effective date of the contract directly pursuant to the negotiation and in anticipation of the contract award when such incurrence is necessary to comply with the proposed contract delivery schedule. Such costs are allowable to the extent that they would have been allowable if incurred after the date of the contract (see 31.109).

31.205-33 Professional and consultant service costs.

(a) Costs of professional and consultant services rendered by persons who are members of a particular profession or possess a special skill and who are not officers or employees of the contractor are allowable subject to paragraphs (b), (c), (d), and (e) below when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see 31.205-30).

(b) In determining the allowability of costs (including retainer fees) in a particular case, no single factor or any special combination of factors is necessarily determinative. However, the following factors, among others, should be considered:

(1) The nature and scope of the service rendered in relation to the service required.

(2) The necessity of contracting for the service, considering the contractor's capability in the particular area.

(3) The past pattern of such costs, particularly in the years prior to the award of Government contracts.

(4) The impact of Government contracts on the contractor's business.

(5) Whether the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly when the services rendered are not of a continuing nature and have little relationship to work under Government contracts.

(6) Whether the service can be performed more economically by employment rather than by contracting.

(7) The qualifications of the individual or concern rendering the service and the customary fee charged, especially on non-government contracts.

(8) Adequacy of the contractual agreement for the service (e.g., description of the service; estimate of time required; rate of compensation; termination provisions).

(c) Retainer fees to be allowable must be supported by evidence that—

(1) The services covered by the retainer agreement are necessary and customary;

(2) The level of past services justifies the amount of the retainer fees (if no services were rendered, fees are not automatically unallowable); and

(3) The retainer fee is reasonable in comparison with maintaining an in-house capability to perform the covered services, when factors such as cost and level of expertise are considered.

(d) Costs of legal, accounting, and consultant services and directly associated costs incurred in connection with organization and reorganization (also see 31.205-27), defense of antitrust suits, defense against Government claims or appeals, or the prosecution of claims or appeals against the Government (see 33.201) are unallowable (but see 31.205-47). Such costs incurred in connection with patent infringement litigation are unallowable unless otherwise provided for in the contract.

(e) Except for retainers, fees for services rendered shall be allowable only when supported by evidence of the nature and scope of the service furnished. (Also see 31.205-38(c).)

(f) Costs of legal, accounting, and consultant services and directly associated costs incurred in connection with the defense or prosecution of lawsuits or appeals between contractors arising from either (1) an agreement or contract concerning a teaming arrangement, a joint venture, or similar arrangement of shared interest; or (2) dual sourcing, coproduction, or similar programs, are unallowable, except when (i) incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer, or (ii) when agreed to in writing by the contracting officer.

31.205-34 Recruitment costs.

(a) Subject to paragraphs (b) and (c) below, and provided that the size of the staff recruited and maintained is in keeping with workload requirements, the following costs are allowable:

(1) Costs of help-wanted advertising.

(2) Costs of operating an employment office needed to secure and maintain an adequate labor force.

(3) Costs of operating an aptitude and educational testing program.

(4) Travel costs of employees engaged in recruiting personnel.

(5) Travel costs of applicants for interviews.

(6) Costs for employment agencies, not in excess of standard commercial rates.

(b) Help-wanted advertising costs are unallowable if the advertising—

(1) Is for personnel other than those required to perform obligations under a Government contract;

(2) Does not describe specific positions or classes of positions;

(3) Is excessive relative to the number and importance of the positions or to the industry practices;

(4) Includes material that is not relevant for recruitment purposes, such as extensive illustrations or descriptions of the company's products or capabilities;

(5) Is designed to "pirate" personnel from another Government contractor; or

(6) Includes color (in publications).

(c) Excessive compensation costs offered to prospective employees to "pirate" them from another Government contractor are unallowable. Such excessive costs may include salaries, fringe benefits, or special emoluments which are in excess of standard industry practices or the contractor's customary compensation practices.

31.205-35 Relocation costs.

(a) Relocation costs are costs incident to the permanent change of duty assignment (for an indefinite period or for a stated period, but in either event for not less than 12 months) of an existing employee or upon recruitment of a new employee. The following types of relocation costs are allowable as noted, subject to paragraphs (b) and (f) below:

(1) Cost of travel of the employee and members of the immediate family (see 31.205-46) and transportation of the household and personal effects to the new location.

(2) Cost of finding a new home, such as advance trips by employees and spouses to locate living quarters, and temporary lodging during the transition periods not exceeding separate cumulative totals of 60 days for employees and 45 days for spouses and dependents, including advance trip time.

(3) Closing costs (i.e., brokerage fees, legal fees, appraisal fees, points, finance charges, etc.) incident

to the disposition of actual residence owned by the employee when notified of transfer, except that these costs when added to the costs described in subparagraph (a)(4) below shall not exceed 14 percent of the sales price of the property sold.

(4) Continuing costs of ownership of the vacant former actual residence being sold, such as maintenance of building and grounds (exclusive of fixing up expenses), utilities, taxes, property insurance, mortgage interest, after settlement date or lease date of new permanent residence, except that these costs when added to the costs described in subparagraph (a)(3) above, shall not exceed 14 percent of the sales price of the property sold.

(5) Other necessary and reasonable expenses normally incident to relocation, such as disconnecting and connecting household appliances; automobile registration; driver's license and use taxes; cutting and fitting rugs, draperies, and curtains; forfeited utility fees and deposits; and purchase of insurance against damage to or loss of personal property while in transit.

(6) Costs incident to acquiring a home in a new location, except that (i) these costs will not be allowable for existing employees or newly recruited employees who, before the relocation, were not homeowners and (ii) the total costs shall not exceed 5 percent of the purchase price of the new home.

(7) Mortgage interest differential payments, except that these costs are not allowable for existing or newly recruited employees who, before the relocation, were not homeowners and the total payments

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are limited to an amount determined as follows:

(i) The difference between the mortgage interest rates of the old and new residences times the current balance of the old mortgage times 3 years.

(ii) When mortgage differential payments are made on a lump sum basis and the employee leaves or is transferred again in less than 3 years, the amount initially recognized shall be proportionately adjusted to reflect payments only for the actual time of the relocation.

(8) Rental differential payments covering situations where relocated employees retain ownership of a vacated home in the old location and rent at the new location. The rented quarters at the new location must be comparable to those vacated, and the allowable differential payments may not exceed the actual rental costs for the new home, less the fair market rent for the vacated home times 3 years.

(9) Cost of canceling an unexpired lease.

(b) The costs described in paragraph (a) above must also meet the following criteria to be considered allowable:

(1) The move must be for the benefit of the employer.

(2) Reimbursement must be in accordance with an established policy or practice that is consistently followed by the employer and is designed to motivate employees to relocate promptly and economically.

(3) The costs must not otherwise be unallowable under Subpart 31.2.

(4) Amounts to be reimbursed shall not exceed the employee's actual expenses, except that for miscellaneous costs of the type discussed in subparagraph (a)(5) above, a flat amount, not to exceed $1,000, may be allowed in lieu of actual costs.

(c) The following types of costs are not allowable:

(1) Loss on sale of a home.

(2) Costs incident to acquiring a home in a new location as follows:

(i) Real estate brokers fees and commissions.

(ii) Cost of litigation.

(iii) Real and personal property insurance against damage or loss of property.

(iv) Mortgage life insurance.

(v) Owner's title policy insurance when such insurance was not previously carried by the employee on the old residence (however, cost of a mortgage title policy is allowable).

(vi) Property taxes and operating or maintenance costs.

(3) Continuing mortgage principal payments on residence being sold.

(4) Payments for employee income or FICA (social security) taxes incident to reimbursed relocation costs.

(5) Payments for job counseling and placement assistance to employee spouses and dependents who were not employees of the contractor at the old location.

(6) Costs incident to furnishing equity or nonequity loans to employees or making arrangements with lenders for employees to obtain lower-than-market rate mortgage loans.

(d) If relocation costs for an employee have been allowed either as an allocable indirect or direct cost, and the employee resigns within 12 months for reasons within the employee's control, the contractor shall refund or credit the relocation costs to the Government.

(e) Subject to the requirements of paragraphs (a) through (d) above, the costs of family movements and of personnel movements of a special or mass nature are allowable. The cost, however, should be assigned on the basis of work (contracts) or time period benefited.

(f) Relocation costs (both outgoing and return) of employees who are hired for performance on specific contracts or long-term field projects are allowable if—

(1) The term of employment is not less than 12 months;

(2) The employment agreement specifically limits the duration of employment to the time spent on the contract or field project for which the employee is hired;

(3) The employment agreement provides for return relocation to the employee's permanent and principal home immediately prior to the outgoing relocation, or other location of equal or lesser cost; and

(4) The relocation costs are determined under the rules of paragraphs (a) through (d) above. However, the costs to return employees, who are released from employment upon completion of field assignments pursuant to their employment agreements, are not subject to the refund or credit requirement of paragraph (d).

31.205-36 Rental costs.

(a) This subsection is applicable to the cost of renting or leasing real or personal property, except ADPE (see 31.205-2), acquired under "operating leases" as defined in Statement of Financial Accounting Standards No. 13 (FAS-13), Accounting for Leases. Compliance with 31.205-11(m) requires that assets acquired by means of capital leases, as defined in FAS-13, shall be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges, or over the lease term as amortization charges, as appropriate (but see subparagraph (b)(4) below).

(b) The following costs are allowable:

(1) Rental costs under operating leases, to the extent that the rates are reasonable at the time of the lease decision, after consideration of (i) rental costs of comparable property, if any; (ii) market conditions in the area; (iii) the type, life expectancy, condition,

and value of the property leased; (iv) alternatives available; and (v) other provisions of the agreement.

(2) Rental costs under a sale and leaseback arrangement only up to the amount the contractor would be allowed if the contractor retained title.

(3) Charges in the nature of rent for property between any divisions, subsidiaries, or organizations under common control, to the extent that they do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, facilities capital cost of money, and maintenance (excluding interest or other unallowable costs pursuant to Part 31), provided that no part of such costs shall duplicate any other allowed cost. Rental cost of personal property leased from any division, subsidiary, or affiliate of the contractor under common control, that has an established practice of leasing the same or similar property to unaffiliated lessees shall be allowed in accordance with subparagraph (b)(1) above.

(4) Rental costs under leases entered into before March 1, 1970 for the remaining term of the lease (excluding options not exercised before March 1, 1970) to the extent they would have been allowable under Defense Acquisition Regulation (Formerly ASPR) 15-205.34 or Federal Procurement Regulations section 1-15.205-34 in effect January 1, 1969.

(c) The allowability of rental costs under unexpired leases in connection with terminations is treated in 31.205-42(e).

31.205-37 Royalties and other costs for use of patents.

(a) Royalties on a patent or amortization of the cost of purchasing a patent or patent rights necessary for the proper performance of the contract and applicable to contract products or processes are allowable unless—

(1) The Government has a license or the right to a free use of the patent;

(2) The patent has been adjudicated to be invalid, or has been administratively determined to be invalid;

(3) The patent is considered to be unenforceable; or

(4) The patent is expired.

(b) Care should be exercised in determining reasonableness when the royalties may have been arrived at as a result of less-than-arm's-length bargaining; e.g., royalties—

(1) Paid to persons, including corporations, affiliated with the contractor;

(2) Paid to unaffiliated parties, including corporations, under an agreement entered into in contemplation that a Government contract would be awarded; or

(3) Paid under an agreement entered into after the contract award.

(c) In any case involving a patent formerly owned by the contractor, the royalty amount allowed should not exceed the cost which would have been allowed had the contractor retained title.

(d) See 31.109 regarding advance agreements.

31.205-38 Selling costs.

(a) "Selling" is a generic term encompassing all efforts to market the contractor's products or services, some of which are covered specifically in other subsections of 31.205. Selling activity includes the following broad categories:

(1) Advertising.

(2) Corporate image enhancement including broadly-targeted sales efforts, other than advertising.

(3) Bid and proposal costs.

(4) Market planning.

(5) Direct selling.

(b) Advertising costs are defined at 31.205-1(b) and are subject to the allowability provisions of 31.205-1(d) and (f). Corporate image enhancement activities are included within the definitions of public relations at 31.205-1(a) and entertainment at 31.205-14 and are subject to the allowability provisions at 31.205-1(e) and (f) and 31.205-14, respectively. Bid and proposal costs are defined at 31.205-18 and have their allowability controlled by that subsection. Market planning involves market research and analysis and generalized management planning concerned with development of the contractor's business. The allowability of long-range market planning costs is controlled by the provisions of 31.205-12. Other market planning costs are allowable to the extent that they are reasonable. Costs of activities which are correctly classified and disallowed under cost principles referenced in this paragraph (b) are not to be reconsidered for reimbursement under any other provision of this subsection.

(c) Direct selling efforts are those acts or actions to induce particular customers to purchase particular products or services of the contractor. Direct selling is characterized by person-to-person contact and includes such activities as familiarizing a potential customer with the contractor's products or services, conditions of sale, service capabilities, etc. It also includes negotiation, liaison between customer and contractor personnel, technical and consulting activities, individual demonstrations, and any other activities having as their purpose the application or adaptation of the contractor's products or services for a particular customer's use. The cost of direct selling efforts is allowable if reasonable in amount.

(d) The costs of any selling efforts other than those addressed in paragraphs (b) or (c) of this subsection are unallowable.

(e) Costs of the type identified in paragraphs (b), (c), and (d) of this subsection are often commingled on the contractor's books in the selling expense account because these activities are performed by the sales departments. However, identification and segregation of unallowable costs is required under the provisions of 31.201-6 and 30.405, and such costs are not allowable merely

because they are incurred in connection with allowable selling activities.

(f) Notwithstanding any other provision of this subsection, costs of direct selling efforts, as defined in paragraph (c) of this subsection, incurred in connection with potential and actual Foreign Military Sales, as defined by the Arms Export Contract Act, or foreign sales of military products or services are unallowable on U.S. Government contracts for U.S. Government requirements.

(g) Notwithstanding any other provision of this subsection, sellers' or agents' compensation, fees, commissions, percentages, retainer or brokerage fees, whether or not contingent upon the award of contracts, are allowable only when paid to bona fide employees or established commercial or selling agencies maintained by the contractor for the purpose of securing business (see 3.408-2).

31.205-39 Service and warranty costs.

Service and warranty costs include those arising from fulfillment of any contractual obligation of a contractor to provide services such as installation, training, correcting defects in the products, replacing defective parts, and making refunds in the case of inadequate performance. When not inconsistent with the terms of the contract, such service and warranty costs are allowable. However, care should be exercised to avoid duplication of the allowance as an element of both estimated product cost and risk.

31.205-40 Special tooling and special test equipment costs.

(a) The terms "special tooling" and "special test equipment" are defined in 45.101.

(b) The cost of special tooling and special test equipment used in performing one or more Government contracts is allowable and shall be allocated to the specific Government contract or contracts for which acquired, except that the cost of (1) items acquired by the contractor before the effective date of the contract (or replacement of such items), whether or not altered or adapted for use in performing the contract, and (2) items which the contract schedule specifically excludes, shall be allowable only as depreciation or amortization.

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(c) When items are disqualified as special tooling or special test equipment because with relatively minor expense they can be made suitable for general purpose use and have a value as such commensurate with their value as special tooling or special test equipment, the cost of adapting the items for use under the contract and the cost of returning them to their prior configuration are allowable.

31.205-41 Taxes.

(a) The following types of costs are allowable:

(1) Federal, State, and local taxes (see Part 29), except as otherwise provided in paragraph (b) below that are required to be and are paid or accrued in accordance with generally accepted accounting principles. Fines and penalties are not considered taxes.

(2) Taxes otherwise allowable under subparagraph (a)(1) above, but upon which a claim of illegality or erroneous assessment exists; provided the contractor, before paying such taxes—

(i) Promptly requests instructions from the contracting officer concerning such taxes; and

(ii) Takes all action directed by the contracting officer arising out of subparagraph (2)(i) above or an independent decision of the Government as to the existence of a claim of illegality or erroneous assessment, to (A) determine the legality of the assessment or (B) secure a refund of such taxes.

(3) Pursuant to subparagraph (a) (2) above, the reasonable costs of any action taken by the contractor at the direction or with the concurrence of the contracting officer. Interest or penalties incurred by the contractor for non-payment of any tax at the direction of the contracting officer or by reason of the failure of the contracting officer to ensure timely direction after a prompt request.

(b) The following types of costs are not allowable:

(1) Federal income and excess profits taxes.

(2) Taxes in connection with financing, refinancing, refunding operations, or reorganizations (see 31.205-20 and 31.205-27).

(3) Taxes from which exemptions are available to the contractor directly, or available to the contractor based on an exemption afforded the Government, except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government. When partial exemption from a tax is attributable to Government contract activity, taxes charged to such work in excess of that amount resulting from application of the preferential treatment are unallowable. These provisions intend that tax preference attributable to Government contract activity be realized by the Government. The term "exemption" means freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise.

(4) Special assessments on land that represent capital improvements.

(5) Taxes (including excises) on real or personal property, or on the value, use, possession or sale thereof, which is used solely in connection with work other than on Government contracts (see paragraph (c) below).

(6) Taxes on accumulated funding deficiencies of, or prohibited transactions involving, employee deferred compensation plans pursuant to Section 4971 or Section 4975 of the Internal Revenue Code of 1954, as amended.

(7) Income tax accruals designed to account for the tax effects of differences between taxable income and pretax income as reflected by the books of account and financial statements.

(c) Taxes on property (see subparagraph (b)(5) above) used solely in connection with either non-Government or Government work should be considered directly applicable to the respective category of work unless the amounts involved are insignificant or comparable results would otherwise be obtained; e.g., taxes on contractor-owned work-in-process which is used solely in connection with non-Government work should be allocated to such work; taxes on contractor-owned work-in-process inventory (and Government-owned work-in-process inventory when taxed) used solely in connection with Government work should be charged to such work. The cost of taxes incurred on property used in both Government and non-Government work shall be apportioned to all such work based upon the use of such property on the respective final cost objectives.

(d) Any taxes, interest, or penalties that were allowed as contract costs and are refunded to the contractor shall be credited or paid to the Government in the manner it directs. However, any interest actually paid or credited to a contractor incident to a refund of tax, interest, or penalty shall be paid or credited to the Government only to the extent that such interest accrued over the period during which the contractor had been reimbursed by the Government for the taxes, interest, or penalties.

31.205-42 Termination costs.

Contract terminations generally give rise to the incurrence of costs or the need for special treatment of costs that would not have arisen had the contract not been terminated. The following cost principles peculiar to termination situations are to be used in conjunction with the other cost principles in Subpart 31.2:

(a) *Common items.* The costs of items reasonably usable on the contractor's other work shall not be allowable unless the contractor submits evidence that the items could not be retained at cost without sustaining a loss. The contracting officer should consider the contractor's plans and orders for current and planned production when determining if items can reasonably

be used on other work of the contractor. Contemporaneous purchases of common items by the contractor shall be regarded as evidence that such items are reasonably usable on the contractor's other work. Any acceptance of common items as allocable to the terminated portion of the contract should be limited to the extent that the quantities of such items on hand, in transit, and on order are in excess of the reasonable quantitative requirements of other work.

(b) *Costs continuing after termination.* Despite all reasonable efforts by the contractor, costs which cannot be discontinued immediately after the effective date of termination are generally allowable. However, any costs continuing after the effective date of the termination due to the negligent or willful failure of the contractor to discontinue the costs shall be unallowable.

(c) *Initial costs.* Initial costs (see 15.804-6(f)), including starting load and preparatory costs, are allowable as follows:

(1) Starting load costs not fully absorbed because of termination are nonrecurring labor, material, and related overhead costs incurred in the early part of production and result from factors such as—

(i) Excessive spoilage due to inexperienced labor;

(ii) Idle time and subnormal production due to testing and changing production methods;

(iii) Training; and

(iv) Lack of familiarity or experience with the product, materials, or manufacturing processes.

(2) Preparatory costs incurred in preparing to perform the terminated contract include such costs as those incurred for initial plant rearrangement and alterations, management and personnel organization, and production planning. They do not include special machinery and equipment and starting load costs.

(3) When initial costs are included in the settlement proposal as a direct charge, such costs shall not also be included in overhead. Initial costs attributable to only one contract shall not be allocated to other contracts.

(4) If initial costs are claimed and have not been segregated on the contractor's books, they shall be segregated for settlement purposes from cost reports and schedules reflecting that high unit cost incurred during the early stages of the contract.

(5) If the settlement proposal is on the inventory basis, initial costs should normally be allocated on the basis of total end items called for by the contract immediately before termination; however, if the contract includes end items of a diverse nature, some other equitable basis may be used, such as machine or labor hours.

(d) *Loss of useful value.* Loss of useful value of special tooling, and special machinery and equipment is generally allowable, provided—

(1) The special tooling, or special machinery and equipment is not reasonably capable of use in the other work of the contractor;

(2) The Government's interest is protected by transfer of title or by other means deemed appropriate by the contracting officer; and

(3) The loss of useful value for any one terminated contract is limited to that portion of the acquisition cost which bears the same ratio to the total acquisition cost as the terminated portion of the contract bears to the entire terminated contract and other Government contracts for which the special tooling, or special machinery and equipment was acquired.

(e) *Rental under unexpired leases.* Rental costs under unexpired leases, less the residual value of such leases, are generally allowable when shown to have been reasonably necessary for the performance of the terminated contract, if—

(1) The amount of rental claimed does not exceed the reasonable use value of the property leased for the period of the contract and such further period as may be reasonable; and

(2) The contractor makes all reasonable efforts to terminate, assign, settle, or otherwise reduce the cost of such lease.

(f) *Alterations of leased property.* The cost of alterations and reasonable restorations required by the lease may be allowed when the alterations were necessary for performing the contract.

(g) *Settlement expenses.* (1) Settlement expenses, including the following, are generally allowable:

(i) Accounting, legal, clerical, and similar costs reasonably necessary for—

(A) The preparation and presentation, including supporting data, of settlement claims to the contracting officer; and

(B) The termination and settlement of subcontracts.

(ii) Reasonable costs for the storage, transportation, protection, and disposition of property acquired or produced for the contract.

(iii) Indirect costs related to salary and wages incurred as settlement expenses in (i) and (ii); normally, such indirect costs shall be limited to payroll taxes, fringe benefits, occupancy costs, and immediate supervision costs.

(2) If settlement expenses are significant, a cost account or work order shall be established to separately identify and accumulate them.

(h) *Subcontractor claims.* Subcontractor claims, including the allocable portion of the claims common to the contract and to other work of the contractor, are generally allowable. An appropriate share of the contractor's indirect expense may be allocated to the amount of settlements with subcontractors; provided, that the amount allocated is reasonably proportionate to the relative benefits received and is otherwise con-

sistent with 31.201-4 and 31.203(c). The indirect expense so allocated shall exclude the same and similar costs claimed directly or indirectly as settlement expenses.

31.205-43 Trade, business, technical and professional activity costs.

The following types of costs are allowable:

(a) Memberships in trade, business, technical, and professional organizations.

(b) Subscriptions to trade, business, professional, or other technical periodicals.

(c) When the principal purpose of a meeting, conference, symposium, or seminar is the dissemination of trade, business, technical or professional information or the stimulation of production or improved productivity:

(1) Costs of organizing, setting up, and sponsoring the meetings, symposia, etc., including rental of meeting facilities, transportation, subsistence, and incidental costs;

(2) Costs of attendance by contractor employees, including travel costs (see 31.205-46); and

(3) Costs of attendance by individuals who are not employees of the contractor, *provided* (i) such costs are not also reimbursed to the individual by the employing company or organization, and (ii) the individuals attendance is essential to achieve the purpose of the conference, meeting, symposium, etc.

31.205-44 Training and education costs.

(a) *Allowable costs.* Training and education costs are allowable to the extent indicated below.

(b) *Vocational training.* Costs of preparing and maintaining a noncollege level program of instruction, including but not limited to on-the-job, classroom, and apprenticeship training, designed to increase the vocational effectiveness of employees, are allowable. These costs include (1) salaries or wages of trainees (excluding overtime compensation), (2) salaries of the director of training and staff when the training program is conducted by the contractor, (3) tuition and fees when the training is in an institution not operated by the contractor, and/or (4) training materials and textbooks.

(c) *Part-time college level education.* Allowable costs of part-time college education at an undergraduate or postgraduate level, including that provided at the contractor's own facilities, are limited to—

(1) Fees and tuition charged by the educational institution, or, instead of tuition, instructors' salaries and the related share of indirect cost of the educational institution, to the extent that the sum thereof is not in excess of the tuition that would have been paid to the participating educational institution;

(2) Salaries and related costs of instructors who are employees of the contractor;

(3) Training materials and textbooks; and

(4) Straight-time compensation of each employee for time spent attending classes during working hours not in excess of 156 hours per year where circumstances do not permit the operation of classes or attendance at classes after regular working hours. In unusual cases, the period may be extended (see paragraph (h) below).

(d) *Full-time education.* Costs of tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with full-time education, including that provided at the contractor's own facilities, at a postgraduate but not undergraduate college level, are allowable only when the course or degree pursued is related to the field in which the employee is working or may reasonably be expected to work and are limited to a total period not to exceed 2 school years or the length of the degree program, whichever is less, for each employee so trained.

(e) *Specialized programs.* Costs of attendance of up to 16 weeks per employee per year at specialized programs specifically designed to enhance the effectiveness of managers or to prepare employees for such positions are allowable. Such costs include enrollment fees and related charges and employees' salaries, subsistence, training materials, textbooks, and travel. Costs allowable under this paragraph do not include costs for courses that are part of a degree-oriented curriculum, which are only allowable pursuant to paragraphs (c) and (d) of this subsection.

(f) *Other expenses.* Maintenance expense and normal depreciation or fair rental on facilities owned or leased by the contractor for training purposes are allowable in accordance with 31.205-11, 31.205-17, 31.205-24, and 31.205-36.

(g) *Grants.* Grants to educational or training institutions, including the donation of facilities or other properties, scholarships, and fellowships are considered contributions and are unallowable.

(h) *Advance agreements.*

(1) Training and education costs in excess of those otherwise allowable under paragraphs (c) and (d) of this subsection, including subsistence, salaries or any other emoluments, may be allowed to the extent set forth in an advance agreement negotiated under 31.109. To be considered for an advance agreement, the contractor must demonstrate that the costs are consistently incurred under an established managerial, engineering, or scientific training and education program, and that the course or degree pursued is related to the field in which the employees are now working or may reasonably be expected to work. Before entering into the advance agreement, the contracting officer shall give consideration to such factors as—

(i) The length of employees' service with the contractor;

(ii) Employees' past performance and potential;

(iii) Whether employees are in formal develop-

ment programs; and

(iv) The total number of participating employees.

(2) Any advance agreement must include a provision requiring the contractor to refund to the Government training and education costs for employees who resign within 12 months of completion of such training or education for reasons within an employee's control.

(i) *Training or education costs for other than bona-fide employees.* Costs of tuition, fees, textbooks, and similar or related benefits provided for other than bona-fide employees are unallowable, except that the costs incurred for educating employee dependents (primary and secondary level studies) when the employee is working in a foreign country where public education is not available and where suitable private education is inordinately expensive may be included in overseas differential.

(j) *Employee dependent education plans.* Costs of college plans for employee dependents are unallowable.

31.205-45 Transportation costs.

Allowable transportation costs include freight, express, cartage, and postage charges relating to goods purchased, in process, or delivered. When these costs can be identified with the items involved, they may be directly costed as transportation costs or added to the cost of such items. When identification with the materials received cannot be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent and equitable procedure. Outbound freight, if reimbursable under the terms of the contract, shall be treated as a direct cost.

31.205-46 Travel costs.

(a)(1) Costs for transportation, lodging, meals, and incidental expenses incurred by contractor personnel on official company business are allowable subject to paragraphs (b) through (f) of this subsection. Costs for transportation may be based on mileage rates, actual costs incurred, or on a combination thereof, provided the method used results in a reasonable charge. Costs for lodging, meals, and incidental expenses may be based on per diem, actual expenses, or a combination thereof, provided the method used results in a reasonable charge.

(2) Except as provided in subparagraph (a)(3) of this subsection, costs incurred for lodging, meals, and incidental expenses (as defined in the regulations cited in (a)(2)(i) through (iii) of this subparagraph) shall be considered to be reasonable and allowable only to the extent that they do not exceed on a daily basis the maximum per diem rates in effect at the time of travel as set forth in the—

(i) Federal Travel Regulations, prescribed by the General Services Administration, for travel in the conterminous 48 United States, available on a subscription basis from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, Stock No. 022-001-81003-7;

(ii) Joint Travel Regulations, Volume 2, DoD Civilian Personnel, Appendix A, prescribed by the Department of Defense, for travel in Alaska, Hawaii, The Commonwealth of Puerto Rico, and territories and possessions of the United States, available on a subscription basis from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, Stock No. 908-010-00000-1; or

(iii) Standardized Regulations (Government Civilians, Foreign Areas), Section 925, "Maximum Travel Per Diem Allowances for Foreign Areas," prescribed by the Department of State, for travel in areas not covered in (a)(2)(i) and (ii) of this subparagraph, available on a subscription basis from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, Stock No. 744-008-00000-0.

(3) In special or unusual situations, actual costs in excess of the above-referenced maximum per diem rates are allowable provided that such amounts do not exceed the higher amounts authorized for Federal civilian employees as permitted in the regulations referenced in (a)(2)(i), (ii), or (iii) of this subsection. For such higher amounts to be allowable, all of the following conditions must be met:

(i) One of the conditions warranting approval of the actual expense method, as set forth in the regulations referenced in (a)(2)(i), (ii), or (iii) of this subsection, must exist.

(ii) A written justification for use of the higher amounts must be approved by an officer of the contractor's organization or designee to ensure that the authority is properly administered and controlled to prevent abuse.

(iii) If it becomes necessary to exercise the authority to use the higher actual expense method repetitively or on a continuing basis in a particular area, the contractor must obtain advance approval from the contracting officer.

(iv) Documentation to support actual costs incurred shall be in accordance with the contractor's established practices provided that a receipt is required for each expenditure in excess of $25.00. The approved justification required by (a)(3)(ii) and, if applicable, (a)(3)(iii) of this subparagraph must be retained.

(4) Subparagraphs (a)(2) and (a)(3) of this subsection do not incorporate the regulations cited in (a)(2)(i), (ii), and (iii) in their entirety. Only the coverage in the referenced regulations dealing with special or unusual situations, the maximum per diem rates, and definitions of lodging, meals, and incidental expenses are incorporated herein.

(5) An advance agreement (see 31.109) with respect to compliance with subparagraphs (a)(2) and (a)(3) of this subsection may be useful and desirable.

(b) Travel costs incurred in the normal course of overall administration of the business are allowable and shall be treated as indirect costs.

(c) Travel costs directly attributable to specific contract performance are allowable and may be charged to the contract under 31.202.

(d) Airfare costs in excess of the lowest customary standard, coach, or equivalent airfare offered during normal business hours are unallowable except when such accommodations require circuitous routing, require travel during unreasonable hours, excessively prolong travel, result in increased cost that would offset transportation savings, are not reasonably adequate for the physical or medical needs of the traveler, or are not reasonably available to meet mission requirements. However, in order for airfare costs in excess of the above standard airfare to be allowable, the applicable condition(s) set forth above must be documented and justified.

(e)(1) "Cost of travel by contractor-owned, -leased, or -chartered aircraft," as used in this paragraph, includes the cost of lease, charter, operation (including personnel), maintenance, depreciation, insurance, and other related costs.

(2) The costs of travel by contractor-owned, -leased, or -chartered aircraft are limited to the standard airfare described in paragraph (d) of this subsection for the flight destination unless travel by such aircraft is specifically required by contract specification, term, or condition, or a higher amount is approved by the contracting officer. A higher amount may be agreed to when one or more of the circumstances for justifying higher than standard airfare listed in paragraph (d) of this subsection are applicable, or when an advance agreement under subparagraph (e)(3) of this subsection has been executed. In all cases, travel by contractor-owned, -leased, or -chartered aircraft must be fully documented and justified. For each contractor-owned, -leased, or -chartered aircraft used for any business purpose which is charged or allocated, directly or indirectly, to a Government contract, the contractor must maintain and make available manifest/logs for all flights on such company aircraft. As a minimum, the manifest/log shall indicate—

(i) Date, time, and points of departure;

(ii) Destination, date, and time of arrival;

(iii) Name of each passenger and relationship to the contractor;

(iv) Authorization for trip; and

(v) Purpose of trip.

(3) Where an advance agreement is proposed (see 31.109), consideration may be given to the following:

(i) Whether scheduled commercial airlines or other suitable, less costly, travel facilities are available at reasonable times, with reasonable frequency, and serve the required destinations conveniently.

(ii) Whether increased flexibility in scheduling results in time savings and more effective use of personnel that would outweigh additional travel costs.

(f) Costs of contractor-owned or -leased automobiles, as used in this paragraph, include the costs of lease, operation (including personnel), maintenance, depreciation, insurance, etc. These costs are allowable, if reasonable, to the extent that the automobiles are used for company business. That portion of the cost of company-furnished automobiles that relates to personal use by employees (including transportation to and from work) is compensation for personal services and is unallowable as stated in 31.205-6(m)(2).

31.205-47 Defense of fraud proceedings.

(a) *Definitions.* "Costs," as used in this subsection, include, but are not limited to, administrative and clerical expenses; the cost of legal services, whether performed by in-house or private counsel; the costs of the services of accountants, consultants, or others retained by the contractor to assist it; the salaries and wages of employees, officers, and directors; and any of the foregoing costs incurred before commencing the formal judicial or administrative proceedings which bear a direct relationship to the proceedings.

"Fraud," as used in this subsection, means (1) acts of fraud or corruption or attempts to defraud the Government or to corrupt its agents, (2) acts which constitute a cause for debarment or suspension under 9.406-2(a) and 9.407-2(a) and (3) acts which violate the False Claims Act, 31 U.S.C., sections 3729-3731, or the Anti-Kickback Act, 41 U.S.C., sections 51 and 54.

(b) Costs incurred in connection with defense of any (1) criminal or civil investigation, grand jury proceeding, or prosecution; (2) civil litigation; or (3) administrative proceedings such as suspension or debarment, or any combination of the foregoing, brought by the Government against a contractor, its agents or employees, are unallowable when the charges, which are the subject of the investigation, proceedings, or prosecution, involve fraud or similar offenses (including filing of a false certification) on the part of the contractor, its agents or employees, and result in conviction (including conviction entered on a plea of nolo contendere), judgment against the contractor, its agents or employees, or decision to debar or suspend, or are resolved by consent or compromise.

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(c) In circumstances where the charges of fraud are resolved by consent or compromise, the parties may agree as to the extent of allowability of such costs as a part of such resolution.

(d) Costs which may be unallowable under 31.205-47, including directly associated costs, shall be differentiated and accounted for by the contractor so as to be separately identifiable. During the pendency of any proceeding or investigation covered by paragraph (b) of this subsection, the contracting officer should generally withhold payment of such costs. However, the contracting officer may in appropriate circumstances provide for conditional payment upon provision of adequate security, or other adequate assurance, and agreement by the contractor to repay all unallowable costs, plus interest, if a conviction or judgment is rendered against it.

31.205-48 Deferred research and development costs.

"Research and development," as used in this subsection, means the type of technical effort which is described in 31.205-18 but which is sponsored by, or required in performance of, a contract or grant. Research and development costs (including amounts capitalized) that were incurred before the award of a particular contract are unallowable except when allowable as precontract costs. In addition, when costs are incurred in excess of either the price of a contract or amount of a grant for research and development effort, such excess may not be allocated as a cost to any other Government contract.

31.205-49 Goodwill.

Goodwill, an unidentifiable intangible asset, originates under the purchase method of accounting for a business combination when the price paid by the acquiring company exceeds the sum of the identifiable individual assets acquired less liabilities assumed, based upon their fair values. The excess is commonly referred to as goodwill. Goodwill may arise from the acquisition of a company as a whole or a portion thereof. Any costs for amortization, expensing, write-off, or write-down of goodwill (however represented) are unallowable.

31.205-50 Executive lobbying costs.

Costs incurred in attempting to improperly influence (see FAR 3.401), either directly or indirectly, an employee or officer of the executive branch of the Federal Government to give consideration or to act regarding a regulatory or contract matter are unallowable.

31.205-51 Costs of alcoholic beverages.

Costs of alcoholic beverages are unallowable.

SUBPART 31.3—CONTRACTS WITH EDUCATIONAL INSTITUTIONS

31.301 Purpose.

This subpart provides the principles for determining the cost of research and development, training, and other work performed by educational institutions under contracts with the Government.

31.302 General.

Office of Management and Budget (OMB) Circular No. A-21, Cost Principles for Educational Institutions, revised, provides principles for determining the costs applicable to research and development, training, and other work performed by educational institutions under contracts with the Government.

31.303 Requirements.

(a) Contracts that refer to this Subpart 31.3 for determining allowable costs under contracts with educational institutions shall be deemed to refer to, and shall have the allowability of costs determined by the contracting officer in accordance with, the revision of OMB Circular A-21 in effect on the date of the contract.

(b) Agencies are not expected to place additional restrictions on individual items of cost.

SUBPART 31.4—RESERVED

SUBPART 31.5—RESERVED

SUBPART 31.6—CONTRACTS WITH STATE, LOCAL, AND FEDERALLY RECOGNIZED INDIAN TRIBAL GOVERNMENTS

31.601 Purpose.

This subpart provides the principles for determining allowable cost of contracts and subcontracts with State, local, and federally recognized Indian tribal governments.

31.602 General.

Office of Management and Budget (OMB) Circular No. A-87, Cost Principles for State and Local Governments, Revised, sets forth the principles for determining the allowable costs of contracts and subcontracts with State, local, and federally recognized Indian tribal governments. These principles are for cost determination and are not intended to identify the circumstances or dictate the extent of Federal and State or local participation in financing a particular contract.

31.603 Requirements.

(a) Contracts that refer to this Subpart 31.6 for determining allowable costs under contracts with State, local and Indian tribal governments shall be deemed to refer to, and shall have the allowability of costs determined by the contracting officer in accordance with, the revision of OMB Circular A-87 which is in effect on the date of the contract.

(b) Agencies are not expected to place additional restrictions on individual items of cost.

SUBPART 31.7—CONTRACTS WITH NONPROFIT ORGANIZATIONS

31.701 Purpose.

This subpart provides the principles for determining the cost applicable to work performed by nonprofit organizations under contracts with the Government. A nonprofit organization, for purpose of identification, is defined as a business entity organized and operated

exclusively for charitable, scientific, or educational purposes, of which no part of the net earnings inure to the benefit of any private shareholder or individual, of which no substantial part of the activities is carrying on propaganda or otherwise attempting to influence legislation or participating in any political campaign on behalf of any candidate for public office, and which are exempt from federal income taxation under section 501 of the Internal Revenue Code.

31.702 General.

Office of Management and Budget (OMB) Circular No. A-122, Cost Principles for Nonprofit Organizations, sets forth principles for determining the costs applicable to work performed by nonprofit organizations under contracts (also applies to grants and other agreements) with the Government.

31.703 Requirements.

(a) Contracts which refer to this Subpart 31.7 for determining allowable costs shall be deemed to refer to, and shall have the allowability of costs determined by the contracting officer in accordance with, the revision of OMB Circular A-122 in effect on the date of the contract.

(b) Agencies are not expected to place additional restrictions on individual items of cost.